Ontario Task Force on Financial Institutions

Final Report

Task Force Members
J. Sayles Dupré, Chairman
A. Kendall Dick, Q.C.
Alexander J. Mackintosh, Q.C.

A Report to The Honourable Monte Kwinter,
Minister of Consumer and Commercial Relations

THE ONTARIO TASK FORCE ON FINANCIAL INSTITUTIONS — Final Report

Task Force Members

J. Stefan Dupré, Chairman

A. Rendall Dick, Q.C.

Alexander J. MacIntosh, Q.C.

A Report to

The Honourable Monte Kwinter

Minister of Consumer and Commercial Relations

December, 1985

Ontario Task Force
on
Financial Institutions

101 Bloor Street West
6th Floor
Toronto, Ontario
M5S 1P8

416 / 963-3188

November 18, 1985

The Honourable Monte Kwinter
Minister of Consumer and Commercial
Relations
555 Yonge Street
Toronto, Ontario
M7A 2H6

Dear Minister:

In accordance with the terms of reference given to us on June 13, 1984, we are pleased to submit our Final Report.

Yours sincerely,

J. Stefan Dupré

A. Rendall Dick

Alexander J. MacIntosh

Published by the
Ontario Task Force on Financial Institutions

© Her Majesty the Queen in Right of Ontario, 1985

ISBN 0-7729-0973-3

Additional copies of this report are available from the Ontario Government Bookstore, 880 Bay St., Toronto. Out-of-town customers write to Publications Services Section, 5th Floor, 880 Bay St., Toronto M7A 1N8. Telephone (416) 965-6015. Toll free long distance 1-800-268-7540, in area code 807 dial 0-Zenith 67200. Mastercard and Visa accepted. Cheques and money orders payable to the Treasurer of Ontario. Prepayment required.

STAFF OF THE TASK FORCE

Executive Director

Nancy L. Jamieson

Administrative Officer

Wilma Piovesan

Research Associates

Robert L. Gardner

M.J. Cindy Dymond

Martin Krossel

Ed Hannah

Clay Horner

Tom Smee

Peter Jensen

David Hughes

Support Staff

Baba Torres

Emita Rosado

TABLE OF CONTENTS

		Page
I	The Task Force Report: An Overview	1
II	Financial Institutions: Their Role, Products and Solvency	29
III	The Organization of Government Resources and Responsibilities	37
IV	Deposit Insurance and Compensation Funds	47
V	Financial Institutions: Their Ownership, Internal Practices and Investment Powers	57
VI	Serving the Consumer	71
VII	The Ontario Loan and Trust Corporations Act	79
VIII	The Insurance Industry	95
IX	Credit Unions	101
X	The Securities Industry	107
	Footnotes	121

Chapter I

The Task Force Report: An Overview

The Ontario Task Force on Financial Institutions was announced in June, 1984, with a broad mandate "to examine the organization and operation of [these] institutions in Ontario and determine what pressures on that financial system may require attention from government."[1]

Since then we have endeavoured to canvass the broadest possible range of interests through a process of extensive consultation and enquiry. A series of informal consultations with concerned participants in the financial system was held in the summer and fall of 1984. These served to identify the key issues outlined in our Interim Report, released in January of 1985. Following that report, we solicited the views of the financial community, its client groups and the public on a number of critical issues, notably those of solvency, market efficiency, self-dealing, conflicts of interests, concentration, regulatory approaches, jurisdiction, internationalization of financial transactions, ownership, consumer demand and technology.

The response to that invitation was both wide-ranging and essential to advancing our understanding of the Canadian financial system and in formulating our final recommendations. Almost thirty written submissions were received in response to the Interim Report and two-thirds of the submittants appeared at public hearings held in May and June of this year. We gratefully acknowledge the contribution made to our deliberations by the thoughtful, and often lively, debate which accompanied both our formal and informal proceedings.

In addition to the views expressed by both the industry and its clients, we sought, through a more extensive public opinion survey than the one featured in our Interim Report, to ascertain the views and expectations of consumers with respect to the financial system. As well, research was conducted at the staff level to provide data, clarify issues and analyze arguments advanced in the course of our proceedings. The results of our public opinion survey and our background papers will be made available upon request.

It is clear that events and issues have not remained static. They have moved at a rapid, indeed even a bewildering pace while the work of the Task Force progressed. In the circumstances, we have felt impelled to report within a shortened time frame so that, even if our text is less detailed than it might have been otherwise, our recommendations will be both relevant and timely.

We have seen no evidence since the release of our Interim Report to suggest that the pace or nature of integration within the financial services industry has been diminished or altered. A widening range of products continues to be offered across the regulatory boundaries which ostensibly constrain financial offerings in the Canadian marketplace. Indeed, many of the core functions associated with one of the so-called 'four pillars' are currently offered by other participants. The pronouncement of the 1964 Report of the Porter Commission, echoed in our Interim Report, that "virtually no one feels bound to stay only in the field where he first got his start, and almost everyone is subject to competition from both newcomers and established institutions"[2] has become increasingly true with the passage of time.

This trend was accentuated by legislative and regulatory changes which encouraged greater

competition and the entry of a large number of new participants to the financial services industry. At the same time the business of financial institutions was radically changing throughout the world, with many new products and services being offered and new and sometimes unforeseen risks being assumed. While the benefits of enhanced competition have been apparent in many of the distinct markets in which financial services are offered, it has also become clear that the system of regulation and supervision did not keep pace with these extensive changes. Both in Canada and elsewhere this system proved inadequate to ensure the stability of financial institutions and to anticipate and contain the risks being assumed. Everywhere failures, near failures and expensive bail-outs are raising costs to consumers and depleting public treasuries.

The pattern of failures and near failures, which this year extended to the Canadian banking system which had long been remarkably free of serious difficulties, has shown that no institution, whatever its jurisdiction of incorporation, its particular financial products or its ownership structure, is immune from collapse. Public policy must respond to this reality. It cannot afford to rest on the easy assumption that a particular type of financial business does not have any significant risk of failure because it has been free of problems in the past. Those forming public policy must realize that the great changes occurring within and among financial institutions are generating new risks to which the system of regulation and supervision must respond.

Financial institutions play a unique role in the business of the nation, being entrusted with the savings of Canadians and financing the bulk of their commercial activity. The financial system can only work efficiently if Canadians have confidence in its integrity. Deposit-taking institutions operate with a very large ratio of debt to capital. Any loss of confidence by their depositors may lead to a crippling run on the institution. While the consequence of a loss of confidence is more quickly experienced by a deposit-taking institution than other financial institutions, it can overtake any of the latter and indeed eventually spread to the system itself. Furthermore, as the system becomes more integrated with virtually all participants engaged in deposit taking, for example, life insurance companies through the sale of short-term annuities and securities firms through the pursuit of clients' credit balances, the whole system will be increasingly dependent upon maintaining the confidence of its customers at all times. Given the importance of confidence to financial markets, failures in the financial services industry cannot and must not be regarded in the same light as failures might be in other business activities.

Our research into public attitudes demonstrates that Canadians, far from advocating less regulation of financial institutions, support more or different regulation, designed to enhance the solvency of these institutions and therefore the security of public funds. Furthermore, the public clearly expects that, in the event of financial institution failure, their claims against any such institution will be paid. This expectation is not confined to deposits but extends to the payment of other claims such as life and general insurance proceeds.

The confidence that the public accords to different kinds of financial institutions may be affected by past incidents of failure. In May, 1985, when our survey was conducted, banks enjoyed a higher degree of public confidence than other financial institutions, presumably because of their untroubled past. The Canadian Commercial and the Northland Bank crises of September 1985 undoubtedly affected the relatively robust confidence that our survey results had associated with banks in general four months earlier.

It is the Task Force's view that the demand of the public for, and the perceived need to ensure confidence, and hence stability, make financial institutions a special and different form of enterprise. Participation in the industry must be regarded as a privilege, carrying with it substantial responsibilities. The granting of that privilege and the regulation and supervision of those who have the privilege must ensure that public confidence in the financial system is safeguarded. In formulating our recommendations, *our fundamental premise has been that public confidence in the solvency of the financial system should be regarded as paramount.*

Governments, whatever their political persuasion, have strived to maintain public confidence in the financial system either by propping up failing institutions or by compensating the clients of those that failed. The pattern that emerges with disturbing clarity from recent events is one where publicly managed deposit insurance systems and the taxpayers at large bear the dramatically rising cost of failures that often arise from a combination of inadequate government regulation or supervision and irresponsible behaviour on the part of financial institutions and their clients. The public has thereby assumed — and is paying for — risks that should have been contained by government regulation and managed by internal institutional practices. We view this situation as simply unacceptable.

The enactment of deposit insurance has had the very desirable effect of protecting small depositors. However, it has had unintended consequences that are most undesirable. Without coinsurance features, deposit insurance encourages consumers to be indifferent to the financial state of the institutions with which they deal. Indeed, it has encouraged a behaviour pattern where 'sophistication' consists in reaching for the highest possible rate of return, in the knowledge that insurance makes this practice 'risk-free'. This situation is compounded when the actions of governments arrange for the repayment of all deposits, regardless of the ceilings at which insurance coverage stops. At this juncture, the largest and most sophisticated depositors can afford to ignore the condition of financial institutions and the financial institutions that engage in unsound or imprudent practices can still find a ready market for their deposit-taking services.

We believe that a situation which is tantamount to eliminating all risk in the making of deposits is fundamentally unsound. It will inevitably breed a continuation of the unfortunate failures which have occurred. Recognizing the sense of entitlement that the existing deposit insurance system has generated among the public, and given our sensitivity to the importance of protecting truly small depositors, we do not join the recent Wyman Report[3] in advocating coinsurance from the first dollar, but we do strongly recommend that coinsurance be introduced above the level of $20,000. As for large deposits, we join with those who have strongly condemned the practice of full compensation of depositors in the event of institutional failure. In this regard, we make a number of recommendations designed to contain the pressures that have impelled recourse to this unfortunate practice. Accordingly, we urge that deposit brokers come under regulation by the deposit insurance authorities. In the same vein, we have been most disturbed by the fact that the list of large depositors who have so effectively pressed governments for full compensation in the past contains a large number of publicly funded entities: municipalities, universities, school boards, hospitals and the like. The prevalence of these presumably sophisticated depositors among the claimants of failed institutions is testimony to the fact that 'sophistication' in deposit making consists in reaching for the highest possible return in blind indifference to the soundness of the institutions. We therefore recommend that all publicly financed authorities and institutions be directed to adopt formal policies requiring prudent diversification of their investments, including their deposit funds.

We remain strongly of the view that deposit insurance, provided its coverage and limits are designed to buttress prudent market behaviour, is essential as the ultimate safeguard of public funds entrusted to deposit-taking institutions. We believe that similar safeguards are necessary with respect to other financial institutions, not only because they have come to offer services that are akin to deposit taking but because the public expects assurances that claims, such as those arising from insurance policies, will be paid. Accordingly, we are recommending that the appropriate regulatory authorities should be satisfied that financial institutions not covered by deposit insurance have in place industry-created and administered funds which will give such reasonable assurance. In our view, additional powers should not be granted to financial institutions until the regulatory authorities are satisfied that such programs are in place.

Deposit insurance and compensation fund schemes are only the fail-safe mechanisms of the ongoing financial system. The confidence which is essential to market efficiency depends directly on the extent to which the practices that lead to failure do not arise in the first place or, if they do

arise, are quickly detected and remedied. It is clear that regulatory authorities have been inadequately equipped for the task of supervising the financial institutions under their mandates. We make a number of recommendations designed to broaden and strengthen these mandates.

It is of little use to increase the powers of regulators if the system of regulation does not permit them to recognize dangers before a failure occurs. Accordingly, we believe that it is essential for the regulators of all financial institutions to develop early warning systems which will permit them to identify a problem and require prompt remedial action whenever the practices of financial institutions appear to place their solvency in jeopardy. If such systems are not put in place the regulatory system will prove, once again, to be inadequate either to detect the dangers of insolvency or to minimize consequent losses.

We also believe that the responsibilities of boards of directors and of audit committees for the effective management of financial institutions should be increased. Those responsible for the management of financial institutions should have a duty to develop internally the early warning systems required to detect practices and events causing the financial instability of their institutions. The relations between an institution's management, its outside auditors and its audit committee are of enormous consequence in preventing failures as are requirements which will ensure that regulatory authorities have access to pertinent audit committee information and to the results of early warning systems.

Many financial institutions, in their appearances before the Task Force, requested an extension of their powers and greater freedom in their exercise. With respect to the latter, we advocate greater freedom than has been permitted under the long-standing statutory regulations known as the 'legal list' or 'legal for life' restrictions on investment. In our view, these restrictions are outdated and worse still emit misleading signals as to what constitutes an appropriately safe investment. We support an enhanced freedom within the framework of a prudent investor approach that emphasizes the importance of portfolio diversification. As for extending the powers of financial institutions, what is involved is the question of a further accommodation of the long-standing institutional practice of providing services outside the boundaries of the traditional lines of business.

Our answer to this question lies in considering the importance of competition as the engine of market efficiency in a setting where the confidence generated by conditions of solvency is maintained. Competition in the financial services industry takes place in distinct markets for different financial services, for example, the markets for deposit-taking services, for residential mortgages, and for commercial loans. It is widely acknowledged that entry into these distinct markets by institutions that were already established in other markets effectively enhanced competition. The legislative change that permitted banks to enhance competition by entering the mortgage market in turn bred more competition in the market for retail deposits, as trust companies pursued a greater share of this market through expanded hours of service. On the other hand, however, recent events in particular testify that when market entry has involved newly formed, as distinct from already existing institutions, the outcome has all too often yielded insolvency rather than enhanced competition.

In light of these considerations, we prescribe that conditions for the chartering of new financial institutions be made more stringent with the capital requirements being increased and a greater responsibility being placed on the regulators to be satisfied that the business plan of these new entrants is a sound one. This is necessary because solvency is so critical to the operation of financial markets. At the same time the importance we attach to competition leads us to support, under prescribed conditions, some further extension of existing institutional powers, for example, the expansion of commercial lending powers of trust companies, the ability of financial institutions to engage in networking, and participation in the ownership of securities firms by domestic financial institutions.

We must stress, however, that we are far from disposed to permit a financial institution to engage freely in all facets of the financial services business. Our existing regulatory systems are designed to regulate institutions whose primary business is related to core functions. As recent events

reveal all too clearly, regulators urgently require the statutory, organizational and personnel resources that will enable them to discharge their current responsibilities effectively. This is not the time to devise the regulatory grand designs that would be required if an institution were permitted to engage in all the functions carried out by insurance companies, loan and trust companies, securities firms and banks.

One of the reasons for the creation of this Task Force was the initiatives being taken in the financial community to create what is sometimes described as a 'one-stop financial service shopping centre'. Our survey research indicates considerable public skepticism towards this innovation and, very significantly, reveals that public opinion does not accept the 'one-stop shopping' argument as a rationale for regulatory change. Having rejected the fundamental change that would permit any institution to provide any financial service, we consider that market forces can settle the issue of whether one-stop shopping is attractive, if networking is permitted among different institutions. A properly ordered system of networking should recognize that the provision of different financial services requires personnel with different kinds of expertise and, in particular, that independent agents and brokers, the value of whose services is confirmed by our public opinion research, have a vital role in fostering competition in the markets for many financial services.

The ownership of financial institutions is to us a matter of grave concern. Although widely-held institutions are not insulated from practices that lead to failure, the fact remains that closely-held institutions are particularly vulnerable to unscrupulous and indeed fraudulent practices. In our Interim Report we assigned urgent priority to regulatory prohibitions against self-dealing, that is transactions carried out in the interests of persons with significant influence, control or ownership over a financial institution to the detriment of the financial institution. Our deliberations since the release of our Interim Report have impressed upon us that prohibitions against self-dealing constitute a second-best solution. Clearly, it would have been preferable to prohibit the closely-held ownership of trust and insurance companies as was done in the banking sector.

In the last analysis, assurance that self-dealing will not arise in situations of closely-held ownership requires two acts of faith: the first in the integrity of controlling owners and the second in the capacity of regulators to ensure that self-dealing prohibitions are in fact enforced. More than enough incidents have yielded more than enough evidence to tell us that these acts of faith rest on foundations that are anything but robust. We have therefore concluded that a basic principle of public policy should be to encourage the development of widely-held rather than closely-held institutions. The pursuit of this principle should make policy-makers particularly wary of ownership patterns that have caused financial institutions to become affiliated with conglomerates whose holdings are a mixture of real, that is commercial, and financial enterprises. Moreover, this principle dictates that when approval is sought for changes in ownership or for the privilege of carrying on a financial business, the regulatory authorities should favour applications by widely-held institutions that intend to confine their business activity to the financial sector. The same principle should be an absolute barrier to any relaxation of the statutory rules that have enabled banks to remain widely held.

During our hearings some participants expressed concern about excessive concentration in the financial services industry. In part, this concern may be addressed by the forthcoming changes in competition legislation relating to mergers. However, we believe that in addition to whatever changes are made in that legislation, the Province of Ontario should develop its own policy as to the degree of concentration which it considers to be desirable in the financial service sectors under its jurisdiction. This policy should respond to the public concern that the sources of financial services may become controlled by a small number of participants. Confidence in the integrity and fairness of the system would be shaken by such a development. We do not believe that this issue may be resolved by blanket prohibitions against any institution or class of institution becoming involved in a particular class of business. Rather, we believe that such concerns should be met by examining the extent of concentration in and its effect on each particular market as there may be positive advan-

tages, as we have indicated earlier, in allowing existing financial institutions to expand their existing services. Nevertheless, it is in our view important that when such expansions in powers are requested and when approval is sought for proposed changes in the ownership of existing institutions, the effect of such proposals on competition and concentration should be carefully weighed before the necessary approvals are given.

Special considerations in the realms of ownership and competition have caused us to devote particular attention to securities firms. The core function of these firms, which is market intermediation, distinguishes them from all other financial institutions, whose core functions involve financial intermediation. The recommendations made by the Ontario Securities Commission (OSC) last February called for substantial changes in the rules governing that industry. Its recommendations sought to terminate the so-called exempt market for securities transactions, to open the industry to formal entry by foreign securities firms, and to allow domestic firms enhanced access to capital by permitting, under stipulated conditions, minority ownership of these firms either by foreign dealers or by domestic financial intermediaries.

Our deliberations have led us to differ with the OSC on the key issue of the magnitude of the changes proposed. We do not agree that what the Commission proposes in the realm of foreign entry and ownership is consistent with the long-established policy of the Government of Ontario. The measures proposed by the OSC would require an open and formal change in government policy on domestic control that is for the Cabinet to determine and that in our view should be weighed in the context of Canada's impending bilateral and multilateral trade negotiations, which will include the services sector. The context of these negotiations involves matters that considerably exceed both the mandate of this Task Force and that of the OSC to determine.

Our concern for the state of competition in the securities industry leads us to recommend that the market in exempt securities transactions should remain unregulated for the time being. We believe that the continuation of such an exemption will provide a useful alternative to users of capital and enhance competition in our capital markets. However, lack of precise knowledge concerning the nature of the exempt market should be remedied by requiring that exempt agents provide information to the OSC which can be compiled in a form that will be readily digestible by policy-makers. As for the desirability of enhancing securities industry access to capital, we have recommended that domestic financial intermediaries, under prescribed circumstances, be permitted to own up to 20 percent of a securities firm.

As comprehensive as we have tried to be, our recommendations concerning financial institutions are the product of one task force that was given its mandate at one point in time. The fact is that there can be no such thing as once-and-for-all solutions in matters that affect financial institutions. Financial activity is international in scope and hypersensitive to both long-run and cyclical economic forces. Its regulation transcends our federal-provincial division of jurisdiction and places a premium on effective communication both between governments and among elected decision-makers, policy advisors and administrators. Consequently, we strongly endorse the creation of a federal-provincial consultative body, to be staffed by a permanent secretariat, as a means of continually reviewing all governmental initiatives in this critical sector of the economy.

Public policy towards financial institutions rests upon an amalgam of general economic policy concerns, regulatory policy considerations affecting a wide range of institutions and occupations, and pragmatic knowledge gained in the world of day-to-day regulation and supervision. To meet this challenge, the Government of Ontario should undertake without delay an organizational consolidation under the Ministry of Treasury and Economics of all the various units and agencies whose activities are relevant to financial institutions. Since both the Government of Canada and the Government of Quebec have chosen this Finance or Treasury-centred model of organizing financial institutions policy and administration, adoption of a parallel model by this government should facilitate intergovernmental consultation whether at the level of ministers or of officials.

Having summarized the essence of our deliberations, we close by reproducing below, numbered sequentially by chapter, the text of each of our formal recommendations as they appear in the body of this Report. Save where we prescribe a basic policy principle or advise that there should be federal-provincial consultation, our recommendations address only those matters that are under the constitutional jurisdiction of Ontario.

Chapter III:
The Organization of Government Resources and Responsibilities

Centralizing the Regulatory and Policy-Making Functions

1. Formation of an Office of Financial Institutions in the Ministry of Treasury and Economics

Those functions pertaining to the regulation, supervision and policy direction of financial institutions currently contained in the Ministry of Consumer and Commercial Relations and its regulatory agencies, boards and commissions should be transferred to the Ministry of Treasury and Economics. These functions should be associated with a new division of that ministry, to be designated the Office of Financial Institutions (OFI).

2. Formation of a Policy Committee of the Office of Financial Institutions within the Ministry of Treasury and Economics

A policy committee of the Office of Financial Institutions should be established to review and advise the Deputy Treasurer on all issues pertaining to the regulation, supervision and policy directions of financial institutions, the membership of this committee to consist of the Assistant Deputy Minister, Office of Financial Institutions, the Chairman of the Ontario Securities Commission, the Chairman of OSDIC, the Chairman of the Pension Commission of Ontario, the Superintendent of Deposit Institutions, the Superintendent of Insurance and the Executive Director, Policy Development and Analysis (OFI).

Upgrading Regulatory and Policy-Making Resources

3. Staffing Needs of the Office of Financial Institutions

The staffing needs of the Office of Financial Institutions should be assessed and filled pursuant to a systematic analysis of the additional personnel requirements that are generated by the recommendations in this Report.

4. Importance of Early Warning Systems

a) The Government of Ontario should direct the relevant regulatory authorities to develop and implement such systems as are necessary to ascertain early warnings of adverse changes in the affairs of financial institutions.

b) The statutes governing Ontario financial institutions should be amended to require them to assemble and transmit any data or other evidence to the relevant regulatory authority that the Lieutenant Governor in Council by regulation deems pertinent to the development by these authorities of information systems designed to yield early warnings of adverse changes in the financial condition of these institutions.

5. *Public Policy with Respect to Regulatory Costs*

It should be a principle of public policy that financial institutions be required to pay directly for a significant part of the costs of their regulation by government. In respect of deposit-taking institutions, there should be federal-provincial consultation to determine a mechanism by which such costs could be recovered through deposit insurance premiums and apportioned among governments in accordance with their regulatory obligations. In respect of non-deposit-taking institutions, the Office of Financial Institutions should develop a mechanism through which regulatory costs could be recovered through direct levies on institutions.

Public Disclosure and Public Complaints

6. *Tabling of Information with Standing Committee of the Legislature*

A standing committee of the legislature should be designated as the mandatory recipient of:

(i) a compendium of all new incorporations, changes in ownership and other matters as prescribed in specific recommendations of this Report; and

(ii) all reports required of the Superintendents of Deposit Institutions and Insurance, and of the Chairmen of the Ontario Securities Commission, the Pension Commission of Ontario and the Ontario Share and Deposit Insurance Corporation.

7. *Public Complaints*

The regulatory authorities should be given the powers to investigate conflict of interest complaints raised by members of the public who believe they have been prejudiced in their dealings with a financial institution and to assess the relevant financial institution for the cost of such investigation.

Intergovernmental Relations and Jurisdictional Issues

8. *Creation of a Permanent Consultative Mechanism*

The Governments of Canada, the Provinces and Territories should initiate discussions with a view to establishing a Council

of Ministers Responsible for Financial Institutions, to review and consult on all matters pertaining to the policies and regulatory practices governing financial institutions. The Council should meet as needed, but at minimum twice a year and should be staffed continuously by a permanent secretariat.

9. Jurisdictional Conflicts

It should be a condition of licensing that every financial institution carrying on business in Ontario must conform to Ontario law in the conduct of its business in Ontario. Every financial institution incorporated in a jurisdiction which permits it to carry out functions denied to Ontario chartered institutions should be required to incorporate an Ontario subsidiary in order to carry on business in Ontario.

Chapter IV: Deposit Insurance and Compensation Funds

1. Uniformity of Federal and Provincial Deposit Insurance Coverage

A basic principle of public policy should be to ensure that the coverage and other terms of deposit insurance provided by federal and provincial deposit insurance authorities are uniform.

2. Extent of Deposit Insurance Coverage

The Government of Ontario should make representations to the Government of Canada respecting deposit insurance coverage as follows:

(i) deposits under $20,000 should be fully insured by CDIC;

(ii) deposits from $20,000 to $60,000 should be insured to the extent of 75 percent of the amount exceeding $20,000 but not exceeding $60,000;

(iii) deposits from $60,000 to $80,000 should be insured to the extent of 50 percent of the amount exceeding $60,000 but not exceeding $80,000;

(iv) no deposits whatsoever should be insured to the extent that they exceed $80,000.

3. RRSP's and Deposit Insurance

The Government of Ontario should make representations to the Government of Canada that RRSP funds which are invested in insured deposit instruments remain fully insured up to the $60,000 level, with, as at present, no insurance coverage on amounts above $60,000.

4. Deposit Brokers

a) Financial institutions which use deposit brokers to solicit deposits should be required, as a condition of retaining deposit insurance coverage, to disclose to their deposit-insuring agency the identity of such deposit brokers, the methods and rates of remuneration that they are paying and the percentage of their total deposits which have been placed by deposit brokers.

b) The deposit insurance authorities should establish a system of mandatory registration for all persons who provide deposit brokerage services. The conditions for registration should include the requirement that a registrant must disclose to its clients:

(i) whether a commission is being paid to the deposit broker by the financial institution taking the deposit;

(ii) if so, the amount of that commission and the commission rates paid by the other institutions with which the deposit broker deals;

(iii) the extent to which deposit insurance is available in respect of the deposit in question.

5. Institutional Depositors

The Government of Ontario should direct, through legislative or other appropriate measures, that municipalities, school boards, universities, hospitals and all other institutions or agencies that are under provincial jurisdiction and whose revenue consists in whole or in part of provincial grants or tax deductible donations must adopt and regularly review investment policies that require diversification of their assets including deposits and all other short-term instruments.

6. Industry Compensation Funds

A basic principle of public policy should be to accelerate the development and implementation of industry compensation funds for the protection of individuals who have property and casualty insurance policies or life insurance policies. In pursuit of this principle, any extension of the powers of property and casualty firms, or of life insurance firms, which require legislative change should be held in abeyance until industry compensation funds that have satisfied the regulatory authorities are in place. Coinsurance features should be viewed as a desirable element of any proposed industry compensation fund.

7. Licensing of Extra-Provincial Financial Institutions

It should become a condition of licensing in Ontario that a financial institution be part of an insurance or compensation fund that has been approved by provincial regulatory authorities and that,

in the opinion of these regulatory authorities, offers a reasonable expectation of recovery to Ontario residents in the event of the insolvency of the institution.

8. Deposit Equivalents

The Government of Ontario should undertake to examine contractual arrangements equivalent to deposits which are being developed by financial and non-financial enterprises to determine whether these new methods of accumulating savings should receive the same protection afforded to traditional deposit instruments. This examination should include a review of the adequacy of the securities industry's National Contingency Fund with particular attention to the growth in the size of free credit balances held with securities firms.

9. CDIC Supervisory Functions

a) A formal federal-provincial agreement should be developed pursuant to which the federal regulatory authorities would be primarily responsible for regulating and supervising federally chartered financial institutions, the provincial regulatory authorities would be primarily responsible for regulating and supervising provincially chartered institutions, and both sets of regulatory authorities would have similar obligations to disclose and exchange information, including information as to any inordinate risks being assumed by such institutions between themselves and with Canada Deposit Insurance Corporation (CDIC).

b) The Government of Ontario should make representations to the Government of Canada requesting that at least three persons having regulatory responsibilities in respect of provincially chartered trust and loan companies be selected to sit on the board of CDIC.

Chapter V: *Financial Institutions: Their Ownership, Internal Practices and Investment Powers*

The Ownership of Financial Institutions

1. Widely-Held Ownership as a Policy Principle

A basic principle of public policy should be to encourage the development of widely-held, rather than closely-held, financial institutions.

2. Approval of New Entrants and of Changes in Ownership and Control

In line with a policy to encourage the development of widely-held institutions, the regulatory authorities should:

(i) favour, when approval is sought for new charters or for changes in ownership and control, applications by widely-held institutions that intend to confine their activities to the financial business;

(ii) refrain from approving the creation of closely-held institutions unless there is evident need for new entrants to a financial services market and the closely-held applicant has clear plans to increase public participation with a view to becoming widely held.

3. Banks as Widely-Held Institutions

The Government of Ontario should communicate to the Government of Canada that it strongly endorses the current federal legislation requiring that domestically-owned banks be widely-held institutions and that exemptions from this requirement should not be permitted.

4. Financial Holding Companies as Public Policy

It should be a principle of public policy that ownership links between financial institutions operating under different legislation should be permitted only through a financial holding company, and that the financial holding company device should be made available to domestically-owned banks as well as to other types of financial institutions.

5. Provincial Financial Holding Companies

The Government of Ontario should prepare provincial legislation which will impose a financial holding company requirement with respect to commonly-held financial institutions that are operating under different legislation and are provincially chartered.

6. Provisions of Financial Holding Company Legislation

Through its own initiatives and in consultation with the Government of Canada, the Government of Ontario should strive to secure the enactment of legislation whereby federal and provincial financial holding company legislation will contain similar provisions with respect to the following:

(i) standards governing the formation of financial holding companies that scrutinize the source and integrity of their financing, prohibit financial institutions from holding equity in their holding company, regulate the transfer of funds among institutions under the same holding company, and ensure that any applicable restrictions on the proportion of shares held by a specific party will apply on a consolidated basis to the financial holding company as well as to the financial institutions with which it is affiliated;

(ii) supervision of established financial holding companies that will ensure continued adherence to the standards governing their formation, require approval of any transfer of ownership or change in control, and favour, in the granting of such approval, a widely-held over a closely-held applicant;

(iii) restrictions on cross-directorships that will stipulate that where a group of financial institutions are affiliated with a financial holding company: (1) a director of one financial institution shall not be a director of another financial institution, except where one financial institution is a subsidiary of the other, and (2) no more than one-third of the directors of the financial holding company may be directors of its affiliated financial institutions.

The Internal Practices of Financial Institutions

7. *Audit Committees: Statutory Requirements*

The statutes governing Ontario financial institutions should be amended to require the directors of all such institutions to appoint an audit committee composed entirely of outside directors, and to impose a general duty upon the audit committee of a financial institution to take such steps as are reasonably prudent to assess the financial stability of the financial institution and to obtain and review any information necessary to this assessment.

8. *Audit Committees: Authority to Make Regulations*

Without limiting the generality of the duty imposed in the preceding recommendation, the Lieutenant Governor in Council should be given the power to make regulations setting out specific matters that audit committees must consider in their deliberations and to require that they make reports to the full board of directors on their findings. These regulations should specify that the audit committee must:

(i) interview the auditors of the financial institution at least once per year;

(ii) review annually the financial institution's methods of asset valuation and, in particular, the method for appraising real estate;

(iii) review annually the financial institution's method for dealing with doubtful accounts including the method for establishing the reserve for losses;

(iv) review annually the extent and nature of any obligations of the financial institution which constitute off balance sheet items;

(v) ensure that the institution has an adequate system in place to discover instances of self-dealing and to ensure that the provisions of the legislation governing the financial institution as to self-dealing and conflict of interest are observed;

(vi) review every instance of self-dealing, regardless of its materiality;

(vii) review any instances of suspected fraud, misfeasance or other irregularity, regardless of their materiality;

(viii) review any transactions of the institution that appear to be outside the powers of the financial institution;

(ix) establish an early warning system to monitor the level of risk exposure of the financial institution;

(x) have minutes taken of every audit committee meeting that accurately and fully reflect the proceedings and send promptly copies of these minutes to every director of the financial institution and to the relevant provincial regulator;

(xi) meet at least four times per year.

9. Statutory Duties of Auditors

The statutes governing the regulation of financial institutions in Ontario should be amended to require the auditor of a financial institution to attend all meetings of the audit committee, to make such reports on the work conducted by the auditor, in its capacity as such, or on behalf of the institution, as the auditor deems desirable to assess the financial stability of such institution, and in particular to report to the audit committee every instance of:

(i) self-dealing;

(ii) apparent fraud, misfeasance or other financial irregularity;

(iii) transactions apparently beyond the powers of the institution;

(iv) any transaction that could have an adverse effect on the financial stability of such an institution;

(v) any transaction involving a liability of the financial institution which would constitute an off balance sheet item,

which is discovered in the ordinary course of the audit.

Investment Powers

10. Prudent Investment Standard

The statutes governing the regulation of financial institutions in Ontario should be amended to replace the current investment rules requiring compliance with qualitative tests by a prudent investment standard.

11. Investment Committees

Each loan and trust company, insurance company and credit union should be required by statute to appoint an investment com-

mittee of the board of directors. The investment committee should be required to establish prudent investment standards to be approved with or without modification by the board of directors and to be applied by the corporation in making investment decisions and in managing the investments of the corporation including deposits.

12. Diversification

Diversification should be one of the principal objectives of the investment strategies undertaken by regulated financial institutions. Accordingly, the investment committee should be required, in establishing prudent investment standards, to adopt policies designed to avoid an undue concentration of risks. This can only be done by the establishment of rules that place limits on investments:

(i) in any one corporation;
(ii) in any one industry group;
(iii) in any one region;
(iv) in companies that are associated;
(v) in any particular type of security.

The investment committee should be required to review such investment policies and their implementation on a regular basis and also should be required to review periodically the investment results.

Chapter VI: *Serving the Consumer*

Networking

1. Regulatory Approval of Networking Arrangements

When two or more financial institutions propose to enter into a contractual arrangement in regard to the sale of financial products or services, such an arrangement should require the approval of whichever regulators may be responsible for the supervision of the respective contracting parties. Before approving any arrangement, the regulators should be satisfied that the proposed arrangement will not result in practices that are directly or indirectly akin to tied selling, that the contracting parties possess the necessary expertise to offer the services that are the subject of the arrangement, and that they have procedures in place to guard their customers against any adverse consequences as a result of any conflicts of interest arising from the arrangement. In assessing the desirability of particular networking arrangements, the regulators should take favourable note of arrangements designed to enhance consumer services in small communities.

2. Disclosure of Networking Arrangements

All parties to a networking arrangement should be required to disclose to their customers the existence of the arrangement and any advantage that accrues to them from a referral or sale pursuant to the arrangement.

3. Disclosure of Available Options

All parties to a networking arrangement should be required to disclose to their customers the availability of alternative sources for similar products and services, including independent agents and brokers, and that their customers are free to obtain their requirements from such sources.

Independent Agents and Brokers

4. Independent Agents and Brokers: Maintenance of Role

Given the recognized and important role played by independent agents and brokers in the provision of personal service and objective advice to consumers, the Government of Ontario and the regulatory authorities, in approving legislative initiatives and in particular networking arrangements, should take special care to preserve a climate in which the role played by independent agents and brokers will be supported and maintained.

5. Support of Educational Initiatives

The Government of Ontario should take steps that will assist the associations of independent life and general agents and brokers to offer educational and licensing programs which meet the challenges created by the emergence of new products and services, and which improve the capacity of their members to assess the soundness of the institutions concerning whose products they advise the consumer.

6. Disclosure Requirements for Insurance Agents and Brokers

All insurance agents and brokers should be required to disclose to their customers the extent of their capacity to sell various types of insurance products and the products of a variety of insurers.

Social Assistance Recipients and Financial Services

7. Social Assistance Recipients: Cheque-Cashing

The Government of Ontario should undertake to develop and implement measures to assist social assistance recipients in the cashing of their cheques, including ways

(i) to expand the use of direct-deposit schemes by social service agencies issuing cheques to members of the public; and

(ii) to encourage financial institutions and social service agencies to consult, on an ongoing basis, concerning any other appropriate steps, including the development of photo-identification cards, that will facilitate cheque-cashing by welfare recipients.

8. *Cheque-Cashing and Income Tax Refund Enterprises*

Federal and provincial officials, by directive of the ministers responsible, should undertake to explore means whereby public demand for the services of cheque-cashing businesses and enterprises providing advances on income tax refunds would be reduced, and to examine regulatory measures designed to curtail the charges that are levied for these services.

Conflicts of Interest and Confidentiality of Information

9. *Prohibition on Use of Confidential Information*

There should be a statutory provision, applying to all financial institutions, that prohibits the disclosure of information obtained from any person dealing with the institution to any other person or the use of such information for any purpose within the institution other than the purpose for which such information was provided.

10. *Exception Where Consent Provided*

An exception to the general prohibition should be allowed where the person supplying the information to the institution consents in writing to the use of that information in some other specific transaction.

11. *Waiver of a Fiduciary or Other Obligation*

There should be a statutory requirement that whenever a financial institution enters into a contract with a customer providing for any waiver of any fiduciary or other obligation of the institution to such customer, the waiver shall be ineffective unless the institution establishes that the customer consented to such a waiver after the full consequences of it were explained.

Chapter VII: *The Ontario Loan and Trust Corporations Act*

Entry Requirements

1. *Ongoing Duty of Corporation*

In addition to its statutory responsibility to advise the Superintendent of Deposit Institutions of every change in its board of directors, each corporation should have a continuing statutory responsibility to satisfy the Superintendent of the fitness as to character and competence of its directors.

2. *Ongoing Duty of Regulator*

The fitness as to character and competence of the directors of loan and trust corporations should be reviewed by the Superintendent upon the incorporation or registration of a corporation, and upon notification of a change in the board of directors of a corporation.

3. *Deposit with Standing Committee*

The upgraded entry requirements proposed in the draft consultation act for loan and trust corporations carrying on business in Ontario, such as increased capitalization and more stringent character and competence qualifications, should be further formalized by the addition of a statutory provision that the Superintendent deposit a file with a standing committee of the legislature relating to each newly incorporated or registered corporation and each corporation that has reported a change in its board of directors. The file should take the form of a compendium disclosing the relevant information on the fitness as to character and competence of the board of directors of such corporations and, in the case of each newly incorporated or registered corporation, relevant information as to the matters required to be established to the satisfaction of the Lieutenant Governor in Council or the regulator in respect of such incorporation or registration.

Directors' Duties

4. *Directors Generally*

The provisions of the draft consultation act pertaining to outside directors, limits on cross-directorships and the standard of care required of directors should be enacted substantially as drafted, augmented by the additional responsibilities of directors as prescribed in the foregoing recommendations of this Report.

5. *Management Resources Committee*

The directors of a loan or trust corporation should have an additional statutory duty to appoint a management resources committee composed of outside directors with the responsibility to review management systems, to develop compensation programs, to evaluate the performance of management, to plan for the succession of management and to ensure continuity in the good management of the corporation at all times.

Disclosure

6. *Disclosure of Financial Statements of Corporation*

A statutory duty should be imposed on all registered loan and trust corporations to provide any depositor upon request with a copy of the corporation's most recent annual and most recent interim financial statement and to notify all depositors of the corporation, in writing, at least once annually of their right to obtain such statements.

7. *Disclosure of Related Party Transactions*

Loan and trust corporations should be required to disclose in their financial statements the occurrence of all related party tran-

sactions permitted under Part IX of the Draft Act during the period covered by the statement, together with such information as may be required to permit a person to have an informed judgment about them.

Self-Dealing

8. *The Extent of the Prohibition*

The approach taken in the Draft Act to banning self-dealing should be adopted and, having regard to the inherent dangers of self-dealing, the exemptions to the ban should not be further extended in any way. We reiterate the recommendation in our Interim Report that the overriding policy consideration in drafting the self-dealing provisions of the Act should be to prohibit all non-arm's length transactions in every case unless true market value can be objectively ascertained by independent means and we emphasize that, in regulating self-dealing, greater responsibility on directors and greater regulatory discretion cannot substitute for the impartiality that results from arm's length negotiations.

9. *Consent to Prohibited Transactions*

The exemption provided in section 144 of the Draft Act whereby the Superintendent may consent to an otherwise prohibited conflict of interest transaction should be amended to require that the consent be obtained from the Lieutenant Governor in Council, upon the recommendation of the Superintendent. Such approval should not be granted unless the applicant can establish that the transaction is in the best interests of the corporation.

10. *Report to Standing Committee*

It should be a statutory requirement that every exemption granted under section 144 shall be disclosed in a compendium to be filed by the Superintendent with a standing committee of the legislature.

11. *Reporting of Conflict of Interest*

The duty in section 149 and section 150 of the Draft Act that auditors and persons undertaking professional services for the corporation report to the directors any conflict of interest breach of which they are aware should be revised to require that such reports be made simultaneously to the directors and to the Superintendent.

Conflict of Interest: Shares Held as Fiduciary

12. *Trust Corporation Shares Held as Fiduciary*

The provision in section 143 of the Draft Act prohibiting a trust corporation that holds its own shares as fiduciary from voting or otherwise dealing with such shares except with the consent of the board of directors, should not be conditional on a ten percent

holding but should extend to any shares of the corporation held as a fiduciary.

Regulation

13. Regulatory Powers

The enhanced regulatory powers and structures in the Draft Act should be enacted substantially as drafted.

14. Suspension of Business

Whenever the right of a loan or trust corporation to carry on business is suspended by the Director of Loan and Trust Corporations, the Superintendent or the Lieutenant Governor in Council, the fact of the suspension and the reasons therefor should be disclosed in a compendium to be deposited with a standing committee of the legislature.

Commercial Lending

15. Endorsement of Draft Provisions

The proposals in the Draft Act in respect of commercial lending which place three principal restrictions on the commercial lending of registered loan and trust corporations:

(i) approval of the Superintendent of Deposit Institutions;

(ii) minimum capital of $15,000,000;

(iii) restrictions to ten percent or less of total assets of the corporation

should be enacted.

Commercial Leasing

16. Minimum Capital

In respect of commercial leasing, a further condition to those proposed in the Draft Act should be enacted. Minimum capital of $15,000,000 should be required as a prerequisite to commercial leasing.

Leverage Ratios

17. Increases in Borrowing Multiples to be Approved

Any increases in the borrowing multiple of trust and loan corporations to any amount in excess of ten times the capital base should be approved by the responsible minister or by the Lieute-

nant Governor in Council. Each subsequent increase also should be so approved.

18. Deposit with Standing Committee

Information as to the increases in the borrowing multiples of trust and loan corporations granted in each year should be deposited with a standing committee of the legislature at least once per year in the form of a compendium prepared by the Superintendent of Deposit Institutions.

19. Reduction of Borrowing Multiple

The Superintendent of Deposit Institutions should be required to review the borrowing multiple of each trust and loan corporation at least once per year and where it is determined that the borrowing multiple is too high, the Superintendent, by order and subject to such terms and conditions as may be set out in the order, may reduce the borrowing multiple to any amount that the Superintendent deems in the best public interest, notwithstanding any other provision in the legislation.

Quantitative Limits

20. Common Shares

The quality tests proposed in clause 160(1)(c) of the Draft Act should be eliminated. Any proposed investment in common shares should be considered with regard to the prudent investment standards established by the investment committee and adopted by the board of directors. However, the quantitative restrictions in the Draft Act in respect of investment in common shares should be retained. These restrictions include:

(i) total investment in shares not to exceed 25 percent of total assets; and

(ii) no holding in excess of ten percent of the voting shares of any one body corporate.

21. Preferred Shares

The quality tests proposed in clause 160(1)(d) of the Draft Act should be eliminated. Any proposed investment in preferred shares should be considered with regard to the prudent investment standards established by the investment committee and adopted by the board of directors. However, the quantitative restrictions in the Draft Act in respect of investment in preferred shares should be retained. These restrictions include:

(i) total investment in shares not to exceed 25 percent of total assets; and

(ii) no holding in excess of ten percent of the voting shares of any one body corporate.

22. Consumer Lending

As proposed in the Draft Act, personal loans to any individual should not exceed the greater of $25,000 and the individual's annual income and all personal lending should be done according to the provisions in subsection 160(4) of the Draft Act including the restriction that the aggregate total of such investment is ten percent or less of the total assets of the loan or trust corporation or such lower percentage as the Superintendent of Deposit Institutions may approve.

23. Real Estate for the Production of Income

The amount of investment in real estate for the production of income should be restricted to five percent of total assets; investment in any one parcel of real estate should not exceed one percent.

24. Real Estate for Own Use

The amount of investment in real estate for the corporation's own use should be restricted to an amount equal to the capital base of the corporation.

25. Third and Subsequent Mortgages

The amount of investment in third and subsequent mortgages should be restricted to two percent of the total assets of the corporation.

26. Single Investments

The amount of investment in any single person or persons that to the knowledge of the corporation are 'related' should be restricted to one percent of the total assets of the corporation.

27. 'Open Basket'

The amount of investment in the basket should be restricted to five percent of the total assets of the corporation. The basket clause should be redrafted to clarify that it cannot be used for commercial lending by corporations that have been granted the statutory commercial lending privilege by the Superintendent and that it may be used for commercial lending by any other corporation wishing to gain experience in this area.

28. Investment Limits

The 50 percent investment limit proposed in section 165 of the Draft Act should be enacted.

Chapter VIII:
Insurance Industry

Changes to the Regulation of All Insurance Companies

1. Investment Powers

The statutory provisions respecting the investment powers of insurance companies should be amended to parallel the recommendations made in this Report regarding the investment powers of loan and trust companies.

2. Other Statutory Requirements

The following matters should be reflected in amendments to the *Insurance Act* and should parallel the recommendations made in this Report regarding trust companies:

(i) more appropriate requirements for initial capitalization and the qualifications of incorporators;

(ii) the standard of care of directors and duties of the management resources committee;

(iii) the role and responsibilities of audit committees and the development of early warning systems;

(iv) the qualifications of directors and the restrictions on cross-institutional directorships.

Mutual Life Insurance Companies

3. Capacity of Mutual Life Insurance Companies to Own Subsidiaries or Own Shares in a Financial Holding Company

Provided that there exists a life insurance industry compensation fund that is satisfactory to the regulatory authorities, the Government of Ontario should pursue, in consultation with the Government of Canada, means which will ensure that mutual life insurance companies, as widely-held financial institutions, will not be disadvantaged *vis-à-vis* stock companies in their capacity to affiliate with other financial institutions, whether by way of the organization of a financial holding company or in downstream subsidiaries.

Ontario Farm Mutuals

4. Ontario Farm Mutuals: Ownership of Stock Companies

The Government of Ontario should give notice that it intends to permit Ontario farm mutuals, subject to ministerial approval, to own downstream property and casualty companies that are stock companies on the condition that a satisfactory industry compensation fund for such stock companies has been developed and implemented. Such approval should be subject to a mutual being able

to demonstrate the existence of a business plan, the fitness as to character and competence of directors and its record of experience in the property and casualty business.

Chapter IX: Credit Unions

1. Current Initiatives and Capitalization

The Ministry of Treasury and Economics should examine the initiatives that continue to be pursued by the regulatory authorities and the industry to strengthen the operation of the credit union movement with a particular view to:

(i) assessing the adequacy of compliance with these initiatives;

(ii) accelerating the recovery, by organizational or other means, of credit unions which remain in deficit positions;

(iii) bringing credit unions into positions of adequate capitalization.

2. Preconditions for Change in Credit Union Powers

No extension of the powers of credit unions should be implemented until:

(i) every credit union, through affiliation with a central league or by other means, possesses membership in a stabilization fund that has been approved by the regulatory authorities;

(ii) a revision of credit union legislation applies to credit unions the legislative provisions recommended in this Report as applicable to financial institutions generally;

(iii) a revision of credit union legislation applies to credit unions the legislative provisions recommended in this Report as applicable to loan and trust corporations, due account being taken of the special nature of credit unions as co-operative institutions.

3. Review of Conflict of Interest and Self-Dealing Possibilities

The Ministry of Treasury and Economics should review and report upon the singular aspect of the credit union system where the depositors, borrowers and directors are all equity owners to ensure that the latent possibility of conflicting interests may not have any prejudicial effect on the operation of a credit union.

4. Authorization of Commercial Lending

a) Subject to the conditions outlined in Recommendation 2, a credit union which has assets in an amount equal to or greater than $15,000,000 should be permitted to engage in commercial lending

to corporations which are not members of the credit union, such lending to be subject to the provision that all corporate lending, to both members and non-members combined, will not exceed the amount which is equal to seven percent of the total of unimpaired capital, deposits and surplus or, if approval of the regulatory authority has been obtained, will not exceed fifteen percent of this total.

b) Credit unions should not be permitted to engage in commercial leasing at this time.

c) The basket clause should be amended to provide unambiguously that it may not be regarded as authorization for a credit union to engage in commercial lending or commercial leasing of any kind.

5. Federal-Provincial Liaison and Exchange of Information

The Government of Ontario should enter into formal consultations with the Government of Canada concerning the means whereby there could be ongoing liaison and reciprocal exchanges of information regarding the Canadian Co-operative Credit Society which is under the regulatory mandate of the federal Superintendent of Insurance and the central leagues which are under the regulatory mandate of the Ontario Director of Credit Unions.

Chapter X: *The Securities Industry*

Foreign Entry and Non-Resident Ownership of the Ontario Securities Industry

1. Foreign Entry and Foreign Ownership

Any changes affecting foreign entry into the Ontario securities industry, the existing 10/25 foreign ownership standard and the current status of grandfathered firms should be held in abeyance so that these matters can be the subject of a formal and open declaration of policy by the Government of Ontario. In formulating its declaration, the Government of Ontario should take into account the larger context of bilateral and multilateral trade negotiations which encompass the provision of services and entail federal-provincial consultation over formulation of Canadian positions.

Capital Adequacy, Access to Capital and Competitiveness Within the Securities Industry

2. Non-industry Investment in Securities Firms

a) Non-industry investors, including financial intermediaries, should be permitted to own in the aggregate up to 49 percent of the voting rights in, and 49 percent of the participating securities of, a securities firm registered in the Province of Ontario, provided that no single non-industry investor, including related persons and companies, should be permitted to hold more than 20 percent of either the voting rights or participating securities.

b) If any single non-industry investor, including related persons and companies, owns more than ten percent of either the voting rights in, or the participating securities of, an Ontario securities firm, then industry investors who hold at least 51 percent of the participating securities and at least 51 percent of the voting rights in that securities firm must exercise their voting rights as a single investor.

c) For so long as the existing 10/25 foreign ownership standard is in place, any voting rights or participating securities held by a non-industry investor which is also a non-resident should be characterized as voting rights or participating securities held by both a non-resident and a non-industry investor.

3. *Prohibition Affecting Underwriting by Securities Firms*

A securities firm should be prohibited absolutely from underwriting, whether as principal or agent, any securities of a non-industry investor or any member of a group of related non-industry investors that hold more than ten percent of either the voting rights in, or participating securities of, that securities firm and from underwriting any securities of a person or company related to that non-industry investor or any member of that group of related non-industry investors.

4. *Restrictions on Directors Representing Ownership Interests of Financial Intermediaries*

Any directors representing the ownership interest of a financial intermediary in an Ontario securities firm should be required to absent themselves when any matter in which the financial intermediary that they represent has an interest is being discussed or voted upon by directors.

The Exempt Market

5. *The Exempt Market and Information Required from Exempt Market Participants*

The current exemptions from the prospectus and dealer registration requirements of the *Securities Act* should be maintained, but any participant in the exempt market acting as agent or underwriter for an issuer should be required to provide annually the following information:

(i) capitalization;

(ii) the name of each person or company which is a holder of ten percent or more of any class of its shares and the residency and citizenship or jurisdiction of incorporation of each such holder;

(iii) a statement whether non-residents, either individually or in the aggregate, own 25 percent or more of any class of its shares;

(iv) a statement as to the nature and source of any other financing used by it;

(v) a description of the types of activities in which it and its affiliates regularly are engaged;

(vi) a listing of the exempt transactions, and their dollar value, in which it has engaged during the past year;

(vii) a description of its directors and senior managers, their citizenship, their residency and their experience in financial or market intermediation.

6. *Reporting of Information on Exempt Market Participants*

The Ontario Securities Commission should submit annually to the Government of Ontario a report setting out the information it has collected from exempt market participants.

7. *Limitation on the Scope of the Exempt Market*

The Government of Ontario should direct that any transaction in which an exempt market participant acts as agent or underwriter shall lose its exempt character if the issuer is related to the exempt market participant.

8. *The Gordon Capital Corporation Proposal for Participation in the Exempt Market with a Foreign Partner*

The Ontario Securities Commission should refrain from dealing with any applications, such as the Gordon Capital Corporation proposal to engage in exempt market activities in conjunction with a foreign resident, which would reflect a change in policy towards foreign participation in the Ontario securities industry until the Government of Ontario has provided specific policy direction.

Chapter II

Financial Institutions: Their Role, Products and Solvency

Financial Institutions: Their Role

The role of financial institutions is to facilitate the flow of funds from savers to the users of such savings, either in the form of debt or equity instruments. These intermediaries all perform the essential function of allocating Canadian savings for productive purposes. This all-important function must be carried out in the most efficient manner possible without compromising the solvency of these financial institutions if the capital market is to operate efficiently. The capital market is a complex instrument whose constituent parts are intertwined, both domestically and internationally. Mismanagement of any one major part may have serious effects on the whole system and so on the national economy. Thus, financial institutions play an essential role in the national economy which must be exercised in a manner consistent with the national interest. Accordingly, both in Canada and abroad, the state, in light of its vital interest in an efficient capital market, has subjected the activities of financial institutions to a significant degree of regulation designed to ensure the effective working of the system.

Ontario has a great stake in the financial industry as it provides substantial opportunities for growth within the province and is currently a very important source of employment. As indicated in our Interim Report,[1] 198,000 of the 454,000 Canadians employed in this industry are located in Ontario. Deposit-taking institutions, namely banks, trust companies and credit unions, employ 90,000 people in Ontario. Insurance carriers employ a further 44,600 directly, while some 25,000 are employed as independent insurance agents and brokers. Over 8,000 people are employed in the securities brokerage and underwriting industry. Since many of these actors have had substantial success in competing throughout the world, the financial industry does provide opportunities for further growth and, accordingly, Ontario has a vital interest in its health.

An important feature of the Canadian financial system has been the segregation of the market and financial intermediation functions within capital markets. The Canadian system shares this feature with the American and British financial systems where market intermediaries have acted to "facilitate the change in ownership of financial claims".[2] Thus, the public transfers monies to the market intermediary, generally an investment dealer or stockbroker, for the purchase of the debt or equity of another corporate entity. In doing so, the purchaser accepts an element of market risk which is significantly greater than the public is prepared to assume when it entrusts its savings to a financial intermediary such as a bank, trust company or insurance company. The market intermediation systems of Canada and the United States have been characterized by a large degree of public participation not found to the same extent in systems in which market and financial intermediation are highly integrated.

A recent study comparing the capital markets of the United States, Canada, Japan, Germany, the Netherlands, France and Venezuela concluded that in Japan, the United States and Canada, where there has been an enforced separation of bank and securities market operations, the securities

markets were deeper and more developed. These countries had the highest ratios of securities aggregates to gross national product (GNP). In particular, it was noted that the Canadian securities market is very deep; the ratio of total securities to GNP was second only to that of the United States and both the bond and share markets were very large. The study found that European countries with universal banking systems have much shallower securities markets.[3]

Unlike market intermediaries, financial intermediaries, such as banks, trust companies, credit unions and insurance companies, take the savings of their customers and issue claims upon themselves. The funds so generated are then employed by such institutions to finance in one way or another the business and personal financial needs of others.

The Canadian economy has also been characterized by a distinction between the financial sector and what is sometimes called the 'real' sector, *i.e.*, commercial and industrial operations. This distinction has been maintained by legislative and regulatory requirements which have prevented, in large part, the intermingling of financial businesses with other commercial and industrial operations. One consequence of this distinction has been that the users of savings have been required, by and large, to obtain funds either from financial intermediaries or through using the services of market intermediaries, rather than by approaching the public directly. Accordingly, they have been required to satisfy these intermediaries of the soundness of their plans for the use of such funds, a practice which has injected a salutary discipline into the system.

Recently, control of a significant number of financial institutions has been acquired by interests that also control substantial industrial and commercial undertakings. This development has created more problems for the efficient operation of capital markets as, in such circumstances, reliance cannot be always placed on the self-interest of those in control of such financial institutions to allocate credit and investment in the most prudent manner. Instead, the risk for the system is that the discipline which is characteristic of a separation between the real and the financial sectors may be lost.

A striking characteristic of deposit-taking institutions is that the funds supplied by shareholders represent a miniscule part of their capital. Such institutions tend to have very high leverage ratios, frequently in excess of 20:1, as evidenced by Table 1. Deposit-taking institutions can operate quite safely, as the Canadian experience demonstrates, with such a relatively small amount of their total capitalization represented by equity, but the margin for error is relatively small. Their assets cannot be readily realized, but a large proportion of their liabilities consist of claims payable on demand or within a very short period. Thus, the viability of such institutions can be easily destroyed by a loss of confidence by their depositors, leading to a run on deposits, or equally by significant losses impairing the relatively small equity component of their capitalization.

The ability to operate with such extensive leverage creates a great temptation to engage in excessive risk taking. If, by taking high risks, a financial institution earns extraordinary returns, the shareholders will reap extraordinary profits. However, if these extraordinary risks result in extraordinary losses, the potential losses of deposit holders will vastly exceed the losses of the shareholders. When the deposit holder is freed from risk, either by deposit insurance or by government action, the deposit holder is not required to place much value on the prudence with which a financial institution manages its affairs. The result has been that in some cases deposit-taking institutions have been free to assume extraordinary risks without the discipline which lenders or depositors concerned for the security of their funds would normally impose. Moreover, in a closely-held institution, as noted by Professor James Pesando, the risk-taking incentive of a dominant shareholder will not only be unchecked by depositors' interests, but is unlikely to be checked by the influence of other equity holders, whose interests are frequently represented solely by directors selected by the dominant shareholder or by the managers whose careers the dominant shareholder controls.[4] In such circumstances, credit is truly without a guardian. Obviously, the existence of the power to use leverage so extensively calls for very prudent management and for close supervision by the regulatory authorities, having regard to the public interest in the solvency of such institutions.

The Canadian financial community consists of a very large number of institutions which

Table 1: Leverage Ratios — Canadian Deposit-Taking Institutions

	Federal	Provincial	
1. Banks	(Actual ratios are being set on a bank-by-bank basis. The following are guidelines.)		
— large, well diversified banks	total assets to total capital: maximum of 30X.	N/A	
— small banks	total assets to total capital: maximum of 20X.	N/A	
— Schedule "B" banks	domestic assets to authorized capital: maximum of 20X; total assets to total capital: maximum of 20X for first three years of operation; after three years of operation and if primary capital is beyond $15 million, maximum of 25X.[1]	N/A	
2. Credit Unions and Caisses Populaires	borrowings, deposits and guaranteed funds to excess of assets over liabilities: maximum of 10X (Minister of Finance may increase ratio to maximum of 20X).[2]	assets to surplus and capital: maximum of 20X.[3]	
		L.T.C.A.[5]	**Consultation Draft**[7]
3. Trust Companies	deposits and borrowings to excess of assets over liabilities: maximum of 12½X (Minister of Finance may increase ratio beyond 12½X, but standards prescribed by regulations must be met to exceed 20X).[4]	deposits and borrowings to excess of assets over liabilities: maximum of 12½X, but standards prescribed by regulations must be met to exceed 20X.[5, 6]	deposits and borrowings to capital base: maximum of 10X (Superintendent may increase ratio up to maximum of 25X).[7]
4. Loan Companies	deposits and borrowings to excess of assets over liabilities: maximum of 4X (Minister of Finance may increase ratio beyond 4X, but standards prescribed by regulations must be met to exceed 20X).[8]	deposits and borrowings to excess of assets over liabilities: maximum of 4X (Cabinet may increase ratio beyond 4X, but standards prescribed by regulations must be met to exceed 20X).[5, 9]	deposits and borrowings to capital base: maximum of 10X (Superintendent may increase ratio up to maximun of 25X).[7]

1. *Bank Act*, S.C. 1980-81-82-83, c. 40, s. 2; "Definition of Capital for the Purposes of Measuring the Capital Adequacy of Canadian Banks", Guideline from the Office of the Inspector General of Banks, March 3, 1983; "Supplement to Definition of Capital for Purposes of Measuring the Capital Adequacy of Canadian Banks", Guideline from the Office of the Inspector General of Banks, July 15, 1983.
2. *Cooperative Credit Associations Act*, R.S.C. 1970, c. C-29 as amended.
3. *Credit Unions and Caisses Populaires Act*, R.S.O. 1980, c. 102 as amended.
4. *Trust Companies Act*, R.S.C. 1970, c. T-16 as amended;
   Financial Standards (Trust Companies) Regulations, CRC, Vol. XVIII, c. 1567, p. 13873 as amended.
5. *Loan and Trust Corporations Act*, R.S.O. 1980, c. 249 as amended.
6. Regulation 591 under the *Loan and Trust Corporations Act*, R.R.O. 1980, p. 641, as amended.
7. *The Loan and Trust Corporations Act, a draft for consultation* (Toronto: Ministry of Consumer and Commercial Relations, June 1985).
8. *Loan Companies Act*, R.S.C. 1970, c. L-12 as amended;
   Financial Standards (Loan Companies) Regulations, CRC, Vol. IX, c. 1028, p. 7997 as amended.
9. Regulation 590 under the *Loan and Trust Corporations Act*, R.R.O. 1980, p. 637 as amended.

are competing to provide financial services. They range from relatively small participants to participants relatively large by world standards and, in many cases, having extensive operations outside Canada. What is fundamental to competition in the financial community is that it takes place in distinct markets for different financial services, for example, the markets for retail deposits, mortgages and short-term debt investments. Whether one considers the banking industry, the trust and loan industry, the credit union industry, the insurance industry or the securities industry, the number of competitors seeking business in these various markets is large. Indeed, there are likely more alternatives open to Ontario customers in the financial services field than is the case for most of the other services or commodities that a consumer needs.

Financial Institutions: Their Products

As we noted in our Interim Report, the business of Canadian institutions is not divided into four separate sectors as the 'four pillar' term would indicate. Rather, financial institutions compete aggressively across the boundaries implicit in a four-pillar system seeking the business of the same customers by providing the same or very similar services. In our Interim Report we included a chart prepared by the law firm of Campbell, Godfrey & Lewtas [5] identifying the range of financial products and services offered by financial institutions. That chart clearly illustrated that a very high degree of overlap does exist between the functions performed and products offered by financial and market intermediaries.

Our subsequent examination of the legal constraints upon each of the regulated sectors of the financial services industry with regard to product and service offerings and the actual products and services currently offered yielded two central findings. First, the statutory powers extended to each sector are wide, broadly drafted and permit a great deal of flexibility in the offering of products and services. Second, the substantial amount of overlap in the actual products and services offered by these institutions, demonstrated in the Campbell, Godfrey and Lewtas chart, has been confirmed and indeed may be accelerating with the rapid introduction of new product and service innovations.

The picture which emerges from such an analysis is that of a financial services industry not organized into discrete sectors in which institutions perform and are required by legislation to perform only their core function, but rather an industry organized into discrete markets for specific financial products or services offered by a wide range of financial institutions. There are, of course, legislative limitations on what each of the major components of the financial industry may do, but these limitations clearly do not prohibit the wide degree of overlap within non-core activities which does exists. Nevertheless, the limitations have protected a core function which distinguishes each of the sectors, namely the banking (commercial lending), trust and loan (trust and estate services), insurance (insurance underwriting), and securities (underwriting and full service brokerage) sectors, from one another. Financial institutions have engaged in activities beyond their core functions in essentially two ways:

1. Governments have facilitated the expansion of the activities of financial institutions beyond their core functions through direct legislative change. Thus, revisions to the *Bank Act* permitted banks to engage in residential mortgage lending which had the result of significantly increasing the competition in that business. Credit unions were authorized to purchase and sell mortgages made under the *National Housing Act*. Measures designed to encourage savings, such as the tax changes relating to registered retirement savings plans and registered home ownership savings plans, permitted a wide range of institutions to compete for the savings of Canadians. These are but a few examples of legislative and regulatory change permitting financial institutions to engage in businesses which could not be considered to be part of their core functions.

2. Financial institutions have been able to provide financial services which do not fall within their core function because of the broadly defined legislative powers which such institutions have and their ingenuity in using these powers to enlarge the scope of their activities. Thus, trust companies over many years have so expanded their business that in the field of deposit taking it is frequently difficult to distinguish between their activities and those of banks. Life insurance companies have designed products which are intended to be competitive with the savings instruments issued by banks and trust companies. Securities firms, although restricted from carrying on the business of a bank, an insurance company, a trust company or a loan company, have developed plans which are competitive with the services provided by deposit-taking institutions. One bank has recently ventured into the brokerage field with the establishment of a discount brokerage service. Many more examples could be given of instances where participants have expanded their services beyond what was originally thought to be their core function.

This expansion of activities beyond the core functions has, in many cases, been a useful development enlarging the competition among financial institutions for the benefit of the public. However, the diversification of financial institutions into an ever-expanding range of markets has posed particular problems for regulators and policy-makers who historically have monitored these intermediaries for liquidity and soundness on the basis of their core functions. Obviously, the considerations applicable to the monitoring of a deposit-taking business differ substantially from what would be appropriate for an insurance business. Again, the offering by securities firms of services which are comparable to those of deposit-taking institutions presents new and very different problems for securities regulators. If for no other reason than the public's expectations as to the degree of risk acceptable, these developments generate a clear need for a policy-making and regulatory system which acknowledges the problems inherent in these diversifications of functions and which responds effectively to them.

Financial Institutions: Their Solvency

Given the important role financial institutions play in the capital market and the public's expectations as to the security of the funds entrusted to them, it is essential that the solvency of the system be maintained and that failures be kept to a minimum. As incidents of insolvency have risen dramatically, both at home and abroad, the concerns for the stability of the financial system have increased. It is clear that the public interest demands that every reasonable step be taken to isolate the causes of insolvencies and to prevent their recurrence. However, it would be a mistake in any such appraisal to assume that because failures have largely occurred in certain types of institutions, other institutions are immune from failure. The experience throughout the world demonstrates that no financial business is immune from failure. Moreover, it should not be assumed that our recent history, both in Canada and abroad, offers any sure guide for the future since the roles of financial institutions are rapidly changing, resulting in the assumption of different risks. Nevertheless, we believe that such an examination is useful as there are some lessons to be learned from recent experience and to be applied in determining appropriate legislative and regulatory changes.

Any examination of the recent failures should commence with a recognition that, despite such failures, the Canadian financial system is a very strong one and that Canada does have a very well-developed capital market. The concern must be to maintain and enhance this strength given the importance of the capital market to our national economy. Not all the factors isolated by the Task Force as to the cause of financial institutional failure apply to all of the participants in the system. Nevertheless, it does appear, from an examination of recent American and Canadian experience in-

volving both deposit-taking and non-deposit-taking institutions, that there are a number of causes which are common and may therefore be viewed as warning signals of impending difficulty. In most cases no one cause may be isolated as the reason for a failure but, rather, a number of factors have worked together to bring about an eventual insolvency.

Our ability to quantify the causes of insolvency is extremely limited given the difficulty in isolating the contribution made by different factors, the lack of consistent or complete data bases and the confidential nature of the analyses provided to us by some Canadian regulators. Nonetheless, we are able to identify a number of recurring factors which have led to insolvency, namely,

(i) incidents of self-dealing,
(ii) lack of diversification,
(iii) managerial weakness, and
(iv) new entrants.

Incidents of Self-Dealing

In a substantial number of Canadian and American insolvencies, self-dealing was identified as a central cause of failure. David Slater of the Economic Council of Canada has suggested that one-half of the 28 severe difficulties or failures of Canadian financial institutions since 1980 has been due to "fraud and self-dealing by the owners of the companies involved."[6] Similarly, data compiled by the United States House Subcommittee on Commerce, Consumer and Monetary Affairs (U.S. Congress, 1983 and 1984) on investigations, indictments, guilty pleas and convictions associated with recent bank failures indicate that in 60 percent (and perhaps as many as 69 percent) of these failures, there was actual or probable misconduct by officers, directors and other insiders.[7]

Self-dealing has been a pivotal reason for insolvency in a number of well-publicized Canadian failures. Commissions of inquiry have spent countless hours and many taxpayers' dollars documenting fraud, malfeasance and insider abuses. The major inquiry by Mr. Justice Samuel H.S. Hughes into the failures of the Atlantic Acceptance Corporation, the British Mortgage and Trust Company and other companies documented a web of transactions involving companies with common ownership ties and made many recommendations designed to prevent such abuses.[8] Unfortunately, the lessons to be taken from that inquiry had only a very limited effect. Self-dealing has continued to be a major, if not the primary, factor in many recent failures in the Canadian financial system. Moreover, incidents of self-dealing sometimes coincided with significant change in a controlling ownership interest.

Lack of Diversification

The lack of portfolio diversification by type of instrument, region and business sector has been a common factor in the failures of financial institutions, both in the United States and Canada. Academic analyses of U.S. data suggest that over 60 percent of U.S. commercial bank failures since January 1982 are associated with specific industrial sector declines, namely energy, forest products, real estate and agriculture.[9] A number of well-publicized American failures, such as Penn Square, Abilene National, First of Midland and the run on Continental Illinois, can be traced to rapid loan growth achieved by excessive loan concentration in particular industries or regions suffering an economic malaise.[10] The Standing Committee of the House of Commons on Finance, Trade and Economic Affairs attributed the recent failure of the Canadian Commercial Bank to an over-concentration of loans in a few sectors such as energy and real estate which made the bank more vulnerable to downturns.[11] Both federal and provincial regulators have suggested to us that this lack

of diversification is as prevalent a factor in the failure of a number of non-banking institutions, including trust companies, credit unions and indeed non-deposit-taking institutions, such as insurance companies.

A lack of diversification of liabilities can be as dangerous as a lack of diversification of assets. Thus, failures of deposit-taking institutions often have featured an over-reliance on wholesale deposits, as opposed to retail deposits which are obtained at lower cost than wholesale deposits and are relatively more stable. Wholesale deposits tend to be much more volatile than retail deposits and their withdrawal, despite assurances of central bank support for the institutions involved, can be a major factor in an insolvency. In a series of instances, wholesale depositors have demonstrated that they will quickly abandon any deposit-taking institution if any doubt of its solvency arises, setting in train events which can easily cause it to fail.

Managerial Weakness

The quality of management has been a significant contributing factor to the insolvency of many Canadian and American financial institutions. Such institutions have suffered significant losses because of the failure of management to match assets and liabilities, to assess lending risks properly, to respond quickly to easily identifiable warnings of impending loss, to diversify assets, to establish adequate internal control and early warning systems and to adopt a large number of other management practices which are characteristic of prudently managed financial institutions. Regrettably, the management of some financial institutions has not demonstrated the strength of character required to prevent the excesses of self-dealing with the result that such institutions have failed. It is very clear from the examination of the failures which have occurred that risks involved in the financial business require a skilled and vigilant management and that every effort must be made to be sure that our financial institutions are prudently and effectively managed.

New Entrants

Both the Canadian and American experience suggests that the recent increases in the failure rate of financial institutions may be explained at least partially by the significant increase in the number of new industry entrants which has occurred in both countries. For example, a recent U.S. study demonstrates that newer U.S. banks tend to have higher failure rates than established banks.[12] An analysis of recent Canadian failures also shows that a number of the failing companies were relatively new. In many instances it was not newness, *per se*, which was a causal factor in their insolvency but rather a combination of inadequate capitalization, lack of diversification and inadequate management.

Conclusion

Our analysis of the role, products and solvency of financial institutions has raised a number of concerns and led to a number of conclusions which are fundamental to our recommendations:

1. Market and financial intermediaries serve fundamentally different needs and the separation of their functions has had a positive effect on the Canadian capital market.

2. The separation of the financial sector and the real sector has provided a very useful discipline for the capital market and should not be eroded further.

3. The very high leverage that may be employed by deposit-taking institutions can cause the shareholders of such institutions to favour excessive risk taking which can lead to extraordinary gains for shareholders but also can lead to insolvency.

4. Deposit insurance schemes and the actions of governments in compensating depositors for all losses have freed institutions from the disciplines that vigilant and prudent depositors would ordinarily impose and, consequently, have created a climate in which deposit-taking institutions are relatively free to assume extraordinary and excessive risks.

5. In such circumstances dominant shareholders can direct the financial institutions they control to assume excessive risks, relatively unconstrained by the influence of depositors, managers or other shareholders.

6. The financial services industry is highly competitive, in terms of both the number and diversity of participants who compete to supply the needs of financial consumers in a series of discrete product markets.

7. Entry into these discrete product markets by already established financial institutions expanding their activities beyond their core functions has provided very effective competition; entry into these markets by new financial institutions has been a less effective source of competition to the extent that such institutions have come into being with less than adequate expertise and capitalization.

8. This expansion of activities beyond the core function of the participants in the financial services industry has created new problems for regulators and policy-makers which require a clear recognition that, as the functions of financial institutions change, the system of regulation and supervision must also change.

9. Although the causes of insolvency are numerous, self-dealing, the lack of diversification of assets and liabilities, managerial weakness and the influx of new entrants without adequate plans, management or capital have been major contributors to the increased number of failures of financial institutions.

10. The public interest in an effective capital market and the public's expectations as to that market require the maintenance of an effective regulatory system capable of rapid adjustment to the ever-changing risks being assumed by financial institutions.

Chapter III

The Organization of Government Resources and Responsibilities

The preceding chapter suggests that the Canadian financial services industry is long past the time when it could accurately be described as a 'four-pillar' system. The fact is that industry participants have come to offer an ever-growing variety of products that bring these institutions into direct competition with one another in markets removed from their historical core functions. Policy development, legislation and regulation which ignore this trend will necessarily suffer from compartmentalized information, inadequate expertise and consequent misunderstandings. The resulting duplication and inefficiency can prejudice both the solvency and the efficiency of the financial system.

The implications for the federal government, for provincial governments and for federal-provincial relations are serious. As an Ontario task force we address in this chapter the key organizational and resource implications for the Government of Ontario, with due regard to the capacity of that government to engage itself effectively in the process of federal-provincial relations.

Centralizing the Regulatory and Policy-Making Functions

Within Ontario at present, the process of regulation and policy development is being conducted in many instances by individual ministry branches, agencies or commissions which have responsibility for only one narrow sector of the financial services industry. As a consequence, little regard is paid to the effect which isolated regulatory or policy decisions regarding any one sector may have on any other aspect of the industry or what their aggregate effect might be on the capital markets generally.

The specific responsibility for the regulation of financial institutions incorporated or operating within the Province of Ontario lies within the Ministry of Consumer and Commercial Relations (MCCR). In particular, the Financial Institutions Division of that ministry houses the regulatory and supervisory responsibility for a number *but not all* of the financial institutions operating in Ontario. The Superintendents of Insurance and Deposit Institutions report through the Assistant Deputy Minister of the Financial Institutions Division. Yet, the Chairmen of the Ontario Securities Commission, the Ontario Share and Deposit Insurance Corporation and the Pension Commission of Ontario report directly to the Minister and have no formal, or indeed informal, reporting relationship with this division. Similarly, the licensing of mortgage brokers is domiciled in yet another division of the ministry, the Business Practices Division.

The policy development function has been more fragmented. Policy advice generally flows from agencies, outside consultants and *ad hoc* committees such as this Task Force. In the crucial area of securities regulation, for example, the ministry has not played a significant role in the policy development function. Given that little or no capacity exists within MCCR to review or analyze securities policy, the Ontario Securities Commission, despite a mandate only to administer the *Securities Act*, has been the effective actor in developing recommendations for legislative change. By contrast, the Pension Commission of Ontario has responsibility to supervise private pension plans within the

province but has not played a major role in the development of pensions policy, which is accomplished almost entirely by the Pension and Income Support Policy Branch of the Ministry of Treasury and Economics.

Most importantly, the development of capital markets policy, that is policy relating to finance, debt management and the utilization of cash resources available to the province, is done through the Office of the Treasury, Ministry of Treasury and Economics, in isolation from any of the regulatory or policy development functions performed by MCCR or its agencies. Likewise, a macroeconomic perspective on the financial services sector issues is provided by the Office of Economic Policy, also domiciled within Treasury. Clearly, changes in the legislation and regulations regarding the investment activities of loan and trust companies, pension funds, insurance companies and credit unions can and do have profound effects on our capital markets. Such changes should be the product of a co-ordinated policy development process, in which all regulators play a part and in which the Ministry of Treasury and Economics is a central participant.

These currently fragmented approaches to the implementation and development of policy for the financial services industry have become ill-suited to a context where the industry itself has been becoming much more highly integrated. The advent of financial products or instruments which are deposit equivalents, for example, requires a governmental response that bridges the gaps among securities regulators who must supervise cash management accounts, trust company regulators who must supervise normal demand deposit accounts and insurance regulators who must supervise annuities. Similarly, decisions regarding the expansion of commercial lending powers for trust or insurance companies may have implications for monetary policy generally. A policy-making process which involves the participation of regulators of similar products from differing institutions together with economists having an understanding of monetary policy and capital markets is necessary to advance the quality of deliberation and, ultimately, of regulation.

The overlapping of product markets, moreover, extends the debate to jurisdictional issues, as institutions of varied jurisdictions of incorporation compete in the same markets for the same consumers. Yet, the federal-provincial consultation so necessary to effective regulation and to the resolution of policy differences can be rendered more difficult when there are organizational asymmetries among governments. We are concerned that, with respect to the financial sector, the organization of Ontario's policy and regulatory resources does not parallel that of the two entities most significant to its intergovernmental consultations, the Government of Canada and the Government of Quebec. In both of these instances, virtually all regulatory and policy development functions pertaining to financial institutions are housed within their Departments of Finance.

In view of the desirability of symmetrical decision making for federal and provincial negotiation and the need for an integrated and comprehensive policy towards the financial services industry, we have concluded that the supervisory and policy development functions of the Government of Ontario should be centralized in one ministry. In view of the critical relationship between regulatory change and the efficiency of our capital markets, we believe that the responsibility for these functions should be reassigned to the Ministry of Treasury and Economics, for inclusion in a new division of that ministry to be designated the Office of Financial Institutions. We have concluded that Ontario cannot play an effective role in the regulation and development of the capital market if the present fragmented and uncoordinated approach is permitted to continue. This is evidently a very unsatisfactory situation, having regard to Ontario's vital stake in the capital market and the importance of financial institutions to the Ontario economy. Our view as to this issue is strengthened by events occurring in the United States. The Task Force has in the past year examined the regulatory structure of U.S. capital markets and its financial institutions. Both at the state and federal level there are many agencies involved with the result that both policy development and administration lack coordination and have been ineffective. This situation is widely recognized by most informed observers to be entirely unsatisfactory in today's climate, whatever may have been said for it when financial

institutions could readily be divided into 'four pillars'. Therefore, we believe that a co-ordinated approach to the regulation of financial institutions and development of appropriate policies for such regulation is inevitable and that there are very substantial risks in delaying the necessary changes to our present system. Accordingly, *we recommend that:*

1. Formation of an Office of Financial Institutions in the Ministry of Treasury and Economics

Those functions pertaining to the regulation, supervision and policy direction of financial institutions currently contained in the Ministry of Consumer and Commercial Relations and its regulatory agencies, boards and commissions should be transferred to the Ministry of Treasury and Economics. These functions should be associated with a new division of that ministry, to be designated the Office of Financial Institutions (OFI).

In adopting the organizational model of the federal government and the Province of Quebec, some refinements are essential to enhance the efficacy of the regulatory and policy functions. Vesting responsibility for financial institutions in a single ministry does not guarantee that policy advisors and regulators will consult one another, let alone appreciate the validity of their different perspectives.

Regulators and policy advisors often tend to view the responsibilities of government with regard to the policing or planning of private sector activities from very different perspectives. In the case of financial institutions, regulators have traditionally been more concerned with the solvency of individual institutions and the extent to which legislative change is implementable in practice. Policy advisors have been more preoccupied with the efficiency of the overall financial system and the extent to which legislative change is desirable in theory. Both perspectives are essential to the effective supervision and direction of the financial services industry. Regulators bring a wealth of practical experience to any discussion of policy change, just as policy advisors will bring a broader view of the systemic impact to any discussion of regulatory change. It is imperative that both parties be actively involved in designing regulatory or legislative change. Accordingly, there should be a policy committee established as the necessary forum for the review of all legislative initiatives pertaining to the financial services sector.

The purpose of the committee would be to pool the experience and expertise of its membership, those officials most closely linked to the regulation and development of policy for this sector. Effective pooling would be further supported if the committee's membership included a senior official representing a newly created position devoted entirely to the policy development function (to be designated the Executive Director, Policy Development and Analysis).

In advocating this policy committee, we do not suggest that the independence required by agencies, such as the OSC, in the exercise of their quasi-judicial functions, should be diminished. To the extent that the fulfillment of specific mandates requires the exercise of such quasi-judicial authority, as is the case with the OSC, the Superintendents of Insurance and Deposit Institutions and the Director of the Credit Unions Branch, these agencies or officials must remain independent and report directly to the Minister, as per that authority. But all of these officials and agencies should be represented as members of the policy committee which should be chaired by the Assistant Deputy Minister of the Office of Financial Institutions. Formal reporting relationships would remain unaffected. The existence of this forum would grant the Government of Ontario through the Treasurer and Deputy Treasurer a source of cohesive policy advice on financial institutions and their regulation. Accordingly, *we recommend that:*

2. Formation of a Policy Committee of the Office of Financial Institutions within the Ministry of Treasury and Economics

A policy committee of the Office of Financial Institutions should be established to review and advise the Deputy Treasurer on all issues pertaining to the regulation, supervision and policy directions of financial institutions, the membership of this committee to consist of the Assistant Deputy Minister, Office of Financial Institutions, the Chairman of the Ontario Securities Commission, the Chairman of OSDIC, the Chairman of the Pension Commission of Ontario, the Superintendent of Deposit Institutions, the Superintendent of Insurance and the Executive Director, Policy Development and Analysis (OFI).

Upgrading Regulatory and Policy-Making Resources

Governments must be ultimately responsible for the regulation and supervision of our financial institutions. If government responsibility is to be exercised effectively, the responsible minister must have within his or her own department the resources necessary to permit an informed view of an increasingly complex industry.

Elsewhere in this Report, we make numerous recommendations whose thrust is to enhance greatly the responsibility placed on directors, auditors and other professional advisors. This is essential to supplement and support government regulation, but it does not comprise a substitute.

Unfortunately, directors can, and do, fail to discharge their existing responsibilities. Merely increasing their responsibilities is unlikely to achieve a better performance from directors who either carelessly or consciously concur in decisions detrimental to the corporation. The possibility of maintaining a successful action against a director is unlikely to compensate the public for the losses of a financial institution. The consequences to the public and to governments of the failure of such institutions are far too serious to permit a reliance on the greater responsibility of directors as the principal line of defence against insolvency. The public interest requires effective and vigilant regulation of financial institutions so that the consequences of failures of directors and managers to act prudently may be minimized. Self-regulation has its place, but the evidence that has been heard by this Task Force indicates that the role of government regulation needs to be strengthened, not the reverse. We agree with Professor Seymour Friedland when he stated at our public hearings that self-regulation may be desirable but will not solve the problem.[1]

Our most recent experiences demonstrate that the powers of government regulators and the resources available to them must be strengthened if the public is to be adequately protected. Many of the recommendations of this Task Force seek to enhance these powers and consequently generate a need for additional resources. We consider that systematic assessment of the manpower implications of our Report for the regulatory agencies concerned should constitute a matter of urgent priority. Accordingly, *we recommend that:*

3. Staffing Needs of the Office of Financial Institutions

The staffing needs of the Office of Financial Institutions should be assessed and filled pursuant to a systematic analysis of the additional personnel requirements that are generated by the recommendations in this Report.

Given adequate manpower resources, nothing is more basic to effective regulation than the capacity to discern early warnings that a financial institution may be engaging in practices that will have an adverse effect on its stability. Various recommendations made in subsequent chapters of this Report seek to expand the access of regulators to information concerning the internal practices

of financial institutions, for example, in the form of audit committee minutes that must reflect substantially enhanced committee and auditor responsibilities.

Beyond their access to such information, however, the regulatory authorities should be required to devise systems that will enable them to measure risks of insolvency. Such systems will vary depending upon the nature of the institution and accordingly this Task Force does not consider itself able to recommend any in particular. The assistance of managers and directors will be invaluable in devising them. We deem it essential, however, that the regulatory authorities be able to rely on more than the simple good will of the industry to assemble and transmit the data that are deemed pertinent to the appropriate systems. In light of these considerations, *we recommend that:*

4. Importance of Early Warning Systems

a) The Government of Ontario should direct the relevant regulatory authorities to develop and implement such systems as are necessary to ascertain early warnings of adverse changes in the affairs of financial institutions.

b) The statutes governing Ontario financial institutions should be amended to require them to assemble and transmit any data or other evidence to the relevant regulatory authority that the Lieutenant Governor in Council by regulation deems pertinent to the development by these authorities of information systems designed to yield early warnings of adverse changes in the financial condition of these institutions.

We recognize that increasing the number of persons involved in regulatory and policy functions, as well as upgrading their remuneration and the technology available to them in order to attract and keep the highest calibre staff resources, will require additional expenditures at a time of government restraint.

It is the view of this Task Force that the special nature of the financial services industry and the protection to consumers which flows from its regulation by governments demand a greater degree of industry participation in funding this regulation. We note that the *Bank Act* finances the functions of the Inspector General of Banks through a direct levy on the banking community. We consider that this is an opportune time for the federal and provincial governments to develop, in consultation with one another, equitable means of recovering their regulatory costs. The most appropriate means will of course vary with the type of institution. Thus, for example, the premium structure of Canada Deposit Insurance Corporation (CDIC) could provide an equitable and efficient vehicle for recovering the regulatory costs of deposit-taking institutions, given a mechanism that could apportion the proceeds among governments in accordance with their regulatory obligations. In the case of the insurance industry, to take another example, direct levies might be developed to recover regulatory costs on an equitable basis from both federally and provincially chartered companies. We are content to illustrate the possibilities in a setting where the overriding principle we endorse is the one of cost recovery. In light of these considerations, *we recommend that:*

5. Public Policy with Respect to Regulatory Costs

It should be a principle of public policy that financial institutions be required to pay directly for a significant part of the costs of their regulation by government. In respect of deposit-taking institutions, there should be federal-provincial consultation to determine a mechanism by which such costs could be recovered through deposit insurance premiums and apportioned among governments in accordance with their regulatory obligations. In respect of non-deposit-taking institutions, the Office of Financial Institutions should develop a mechanism through which regulatory costs could be recovered through direct levies on institutions.

Public Disclosure and Public Complaints

We strongly believe that one of the most effective constraints upon unethical behaviour, incompetent management or ineffective regulation is the potentiality of public disclosure.

It has been suggested that a full airing of matters particularly significant to the formation, ownership, management and regulation of individual financial institutions could ensure that owners, managers and regulators will proceed with the utmost prudence in fulfilling their respective mandates. Similarly, a more complete and public disclosure of information regarding the soundness of financial institutions would provide interested depositors and other clients with much of the data necessary to make prudent investment decisions. We consider that the most appropriate vehicle for all such disclosures is a standing committee of the legislature. Accordingly, *we recommend that:*

6. Tabling of Information with Standing Committee of the Legislature

A standing committee of the legislature should be designated as the mandatory recipient of:

(i) a compendium of all new incorporations, changes in ownership and other matters as prescribed in specific recommendations of this Report; and

(ii) all reports required of the Superintendents of Deposit Institutions and Insurance, and of the Chairmen of the Ontario Securities Commission, the Pension Commission of Ontario and the Ontario Share and Deposit Insurance Corporation.

Financial institutions try very hard to create a climate of trust and confidence with their customers and, as the public opinion research commissioned by the Task Force indicates, they do, in large part, command a high degree of trust. The Task Force believes that it is essential to the efficient working of the capital markets that this degree of trust be maintained and that, accordingly, financial institutions and their regulators should take special care that conflicts of interest are resolved in favour of the customer and that the relationship with the customer is one which entitles the customer to place the highest degree of trust and confidence in the financial institution.

All of the legislative and regulatory initiatives taken by the Government of Ontario must be taken with a view to protecting the rights of consumers. In Chapter VI of this Report, we propose that safeguards be put in place to protect consumers who may be put at a disadvantage because of an apparent conflict of interest within a financial institution, because of the disclosure of confidential information or through the breach of a fiduciary or other duty.

At the moment the normal remedy for such a breach is to resort to litigation, the costs of which are often prohibitive. We believe that the regulatory authorities should have the power to investigate conflict of interest complaints and to make the result of such investigations public. Further it is our view that the regulatory authorities should not be given power to provide a specific remedy. Rather, we think that such an investigation would lead in most cases to a resolution of the problem or, if that did not occur, would provide, as a last resort, the factual background for successful litigation if a customer had been damaged by a breach of a fiduciary duty.

To lend further substance to these safeguards and to protect against other conflict of interest situations that may arise, for example, from networking arrangements, we believe that the powers and duties of the regulatory bodies should extend beyond the investigation simply of breaches of their respective statutes to the investigation of conflict of interest complaints made by any persons dealing with a particular financial institution. Such an investigatory power should be assigned to the regulatory authorities as an additional responsibility and should not be the function of a separate

regulatory body, such as a Conflicts of Interest Office. In addition, the cost of investigating a conflict of interest complaint should be assessable against the financial institution. Accordingly, *we recommend that:*

7. Public Complaints

The regulatory authorities should be given the powers to investigate conflict of interest complaints raised by members of the public who believe they have been prejudiced in their dealings with a financial institution and to assess the relevant financial institution for the cost of such investigation.

Intergovernmental Relations and Jurisdictional Issues

In our Interim Report, we stressed the necessity of developing "the most appropriate vehicle for achieving harmony among the policies and regulatory practices governing financial institutions"[2] between the federal and provincial levels of government. A number of participants in our public hearings process eloquently expressed a similar concern for the lack of effective consultation and co-operation between governments.

The importance of federal-provincial harmony in the area of financial services regulation cannot be overstated. The current jurisdictional maze, in which the federal government regulates banking, co-operative credit associations and some segments of the trust and insurance industry while the provinces regulate securities firms, credit unions, independent agents and brokers and the remaining segments of the trust and insurance industry has led to enormous duplication, confusion and, often, conflict between both levels of government.

Such misunderstandings and dual regulation can seriously undermine the efficiency of our Canadian capital markets, by generating additional and often disparate obligations which the industry must fulfil. A number of issues in particular demand a more cohesive, indeed rational, approach. For example, the extension of commercial lending could have a serious impact on the determination of the money supply, a federal concern. Clearly, a solution must be negotiated which meets both of these legitimate interests. Similarly, a decision to allow greater foreign participation in the securities market could play an important role in any Canada-U.S. negotiation of a 'fair' trade arrangement within the services sector. Again, both provincial and federal governments will have a mutual interest in achieving an equitable resolution.

Despite the panoply of formal meetings which currently take place (of provincial securities regulators, of federal-provincial Superintendents of Insurance, of federal-provincial Deputy Ministers of Consumer and Commercial Relations and of Ministers of Consumer and Commercial Relations, of federal-provincial Deputy Ministers of Finance in the Continuing Committee of Officials and of Ministers of Finance) there is no single forum in which all of the relevant actors responsible for the regulation of and development of policy for the financial services industry can meet and resolve issues of mutual concern.

We believe that these issues will not diminish in the near future. Indeed, the pace of and pressure for change within the financial industry suggests that the decision-making agenda for government regulators and policy-makers will be even more crowded in the years to come. Responsible ministers require an ongoing forum, where discussion and negotiation are situated in a national, integrative context. Experience in other domains of federal-provincial relations indicates that the existence of such a forum, even though it may meet only once or twice a year, is enormously conducive to informal, personal contacts among ministers whenever the need arises. Experience also speaks in favour of underpinning ministerial meetings with a permanent secretariat. Accordingly, *we recommend that:*

8. Creation of a Permanent Consultative Mechanism

The Governments of Canada, the Provinces and Territories should initiate discussions with a view to establishing a Council of Ministers Responsible for Financial Institutions, to review and consult on all matters pertaining to the policies and regulatory practices governing financial institutions. The Council should meet as needed, but a minumum twice a year and should be staffed continuously by a permanent secretariat.

The special character of financial institutions and their centrality to the health and efficiency of our capital markets make the regulatory regime for these intermediaries one of the most delicate and politically complex of all interjurisdictional issues. There are a number of outstanding issues that are properly dealt with within the context of the consultative mechanism recommended by this Task Force. Clearly, the ease and timeliness of communication between regulators which would be facilitated by such a federal-provincial body would have been of assistance in resolving the difficulties presented by recent initiatives, such as Quebec's Bill 75. Within a consultative framework, however, Ontario must have a policy of its own which addresses the public's concern for institutional solvency regardless of the jurisdiction of incorporation.

The primary role of the Government of Ontario in this regard is the regulation and supervision of financial institutions incorporated under its own legislation. But it also bears a political responsibility for the protection of Ontario consumers who may be depositors, policyholders or clients of a corporation which has been chartered outside Ontario but must be licensed to do business in this province. In the absence of its own standards of regulation, it is difficult to imagine how the Government of Ontario could insure the interests of its own residents in the event of institutional insolvency. Of similar concern is the protection of Ontario businesses who may be subjected to unfair competition if extra-provincial institutions are permitted greater latitude than Ontario institutions in their business dealings in this province.

The Government of Ontario has proposed adoption of an 'equals approach' as a way of dealing with these concerns. Under this proposal, as a condition of licensing in Ontario, any extra-provincial corporation would have to comply with Ontario law in all of its undertakings, whether in or outside of Ontario. That all corporations should comply with Ontario law within the Province of Ontario is not an issue. Where the equals approach is open to criticism, however, is that it may be viewed as extraterritorial legislation, that is as ordaining what the law must be in other jurisdictions, for any financial institutions wishing to carry on business in Ontario.

We consider that the purpose of the equals approach, which is to protect Ontario residents from insolvencies which may befall institutions chartered in other jurisdictions, could be achieved if there existed industry-wide compensation funds, membership in which was required for an Ontario licence. We urge the development of such funds in the next chapter. Pending their implementation, the equals approach must be relied upon as the only instrument available for the protection of Ontario consumers.

For the time being, therefore, if Ontario maintains the principle that the four pillars should be preserved, and yet other jurisdictions permit a co-mingling of core functions, the Government of Ontario should require any financial institution chartered in a jurisdiction that permits co-mingling to incorporate an Ontario subsidiary if it wishes to operate in Ontario. In this way, Ontario would be able to ensure that the separation of core functions is maintained in all financial institutions dealing with Ontario residents. Accordingly, *we recommend that:*

9. Jurisdictional Conflicts

It should be a condition of licensing that every financial institution carrying on business in Ontario must conform to Ontario law in the conduct of its business in Ontario. Every financial institution incorporated in a jurisdiction which permits it to carry out functions denied to Ontario chartered institutions should be required to incorporate an Ontario subsidiary in order to carry on business in Ontario.

Chapter IV

Deposit Insurance and Compensation Funds

Introduction

The appropriate role to be played by deposit insurance and compensation funds currently is being examined in many quarters. Securities regulators are reviewing the adequacy and structure of the National Contingency Fund, while the life and property/casualty insurance industries, in conjunction with provincial and federal regulators, are considering the establishment of industry-run compensation funds. Recent strains on deposit insurers, especially Canada Deposit Insurance Corporation (CDIC), which is estimated to have currently a deficit of $1.2 billion[1] have focussed attention on deposit insurance schemes. On January 10, 1985, the federal government formed a committee (the "Wyman Committee") whose report[2] on the operations and structure of CDIC was issued on April 25, 1985. Canada is not alone in encountering severe problems with deposit insurance schemes as great strains are being placed on such plans in the United States.

Deposit-taking institutions operating in Ontario obtain deposit insurance from one of two sources: from CDIC for banks and loan and trust companies, and from Ontario Share and Deposit Insurance Corporation (OSDIC) for credit unions. The insurance provided by these two corporations is not uniform. For instance, credit unions claim that the OSDIC legislation provides broader coverage of RRSP funds held in insurable deposits, namely full coverage up to $60,000 for each RRSP contract, while CDIC limits its coverage to a maximum of $60,000 for all RRSP contracts held with an institution. OSDIC's insurance also differs from that of CDIC by covering share capital accounts held by members of Ontario's credit unions; all share capital is fully at risk in any CDIC-insured institution. In both instances, we favour the treatment afforded by CDIC. More generally, to avoid confusion among depositors concerning which types of deposits are insured and to ensure that no type of financial institution is provided with a competitive advantage over other types, we consider it most important that deposit insurance coverage by federal and provincial authorities should be uniform. We are concerned particularly about OSDIC's failure to differentiate between conventional deposits, which should be insured, and share deposits which represent owners' equity and should not be insured. The incentive for credit union members to become involved in the affairs of a credit union is diminished if those members have no risk capital at stake. Accordingly, *we recommend that:*

1. Uniformity of Federal and Provincial Deposit Insurance Coverage

A basic principle of public policy should be to ensure that the coverage and other terms of deposit insurance provided by federal and provincial deposit insurance authorities are uniform.

Extent of Deposit Insurance Coverage

We view the current scheme of deposit insurance as having lowered market discipline as a control over excessive risk taking by deposit-taking financial institutions. This view was shared by several parties making written submissions to this Task Force[3] or appearing at our public hearings,[4] and was stated forcibly by Professor James Pesando in a paper[5] presented at the Conference

on the Changing Regulatory Environment for Canadian Financial Institutions, Toronto, May 22-23, 1985 and in the preliminary version of a later paper[6] provided to the Task Force.

Depositors who are fully insured (or believe that they will be compensated fully for any loss) have no incentive to evaluate the riskiness of deposit-taking institutions when making a deposit decision and indeed simply are encouraged to place their deposits with the institution paying the highest rate. They discern that their deposit is safe, whether the institution fails or not, with the result that the stability of the deposit-taking institution is of no concern to them. Consequently, the managers of such an institution need only be concerned with the wishes of shareholders in determining the degree of risk which their institution should assume. In contrast, managers of institutions with depositors who are not insured fully must satisfy depositors that their institutions are financially sound. In the present environment of *de facto* full insurance, deposit-taking institutions can issue virtually risk-free liabilities even if they invest in very risky assets. The risk, however, is not eliminated but is shifted to those who underwrite deposit insurance (ultimately low risk institutions and possibly taxpayers) and to those governments which respond to the political pressure to compensate fully every depositor of a failed institution.

Recent events testify abundantly to the effectiveness of the political pressures that favour extending coverage to all depositors when governments are faced with an actual insolvency. In his luncheon address at the Conference on the Changing Regulatory Environment for Canadian Financial Institutions on May 23, 1985, the Honourable Robert L. Andrews, Minister of Finance for the Province of Saskatchewan, while discussing the failure of Pioneer Trust, stated that he believed that governments could not decide to leave any depositors unreimbursed after a financial failure. This view has received wide currency throughout the world, as the actions of many governments all too clearly confirm. We take serious issue with these actions, believing that they effectively remove the influence of the market to enforce the prudent management of deposit-taking institutions. They encourage persons making deposits which may be worth millions of dollars to do so with little care, perceiving that governments will save them from the consequences of their own imprudence. Such a perception virtually makes all deposit-taking institutions equally attractive to depositors whether they are managed prudently or imprudently. A situation which is tantamount to eliminating all risks in the making of deposits is fundamentally unsound and inevitably will breed a continuation of the unfortunate failures which have occurred. The concern of governments should be to see to it that the great mass of depositors are protected. Having established a deposit insurance system for this purpose, governments should adhere to its limits scrupulously.

As for that deposit insurance system, we consider that it should incorporate an element of market discipline so as to encourage individuals to weigh risk factors when placing deposits and making investments. The Wyman Committee recommended a system of deposit insurance similar to that of the United Kingdom which involves coinsurance from the first dollar deposited in an attempt to instill a measure of market discipline.[7] In its written submission to this Task Force, the Trust Companies Association of Canada argued for retention of full insurance up to $60,000 arguing that "there is a great amount of evidence to suggest that measures aimed at enhancing depositor diligence are not very effective. The complexity of financial information is such that few but the most sophisticated depositors can make effective use of it. The degree of sophistication required plus the cost to consumers of obtaining and digesting information means that, as in other areas, simple disclosure will not greatly increase market discipline."[8] While appearing before our public hearings, this association also argued that any reduction in the level of deposit insurance would increase barriers to entry because depositors tend to equate size with stability and unsophisticated depositors, not having the time or resources to assess risk, would flock to larger institutions, leading "to the forcing out of some of the smaller companies [and] the reduction of competition."[9]

The Canadian Bankers' Association (CBA) agreed with the principle of coinsurance, but was not in complete agreement with the recommendations of the Wyman Committee's report. The CBA believed that those recommendations "would not fully protect the small and truly unsophisticated depositors from loss and would be a major break from arrangements they have come to expect."[10] It recommended full insurance coverage up to $20,000 and 75 percent coverage of amounts over $20,000 up to a maximum of $75,000. It justified its recommendation by referring to the following statistics, all as of April 30, 1984, about deposits held with Canada's chartered banks:[11]

1. Deposit Accounts Under $60,000:	99 percent of all deposit accounts 65 percent of the dollar value of all deposit accounts
2. Deposit Accounts Under $20,000:	96 percent of all deposit accounts 43 percent of the dollar value of all deposit accounts
3. Deposit Accounts Under $10,000:	91 percent of all deposit accounts 27.5 percent of the dollar value of all deposit accounts
4. Deposit Accounts Under $1,000:	61 percent of all deposit accounts 3 percent of the dollar value of all deposit accounts

After considering the various submissions we received on deposit insurance and particularly the statistics provided by the CBA, we believe that the principle of coinsurance should be embraced, but with a minimum level of full insurance. It is unrealistic to expect small, probably unsophisticated, depositors to incur the relatively high information costs involved in assessing the risk posed by various deposit-taking institutions. Accordingly, we believe that deposits up to a limit of $20,000 should be fully insured. The CBA statistics show that this threshold will protect fully all but approximately four percent of deposit accounts, yet force those with deposits above $20,000 to take steps to assess the risk of their deposit-taking institution or spread their deposits among institutions, placing no more than $20,000 in each institution. We believe that deposits should be insured to the extent of 75 percent of the amount exceeding $20,000 up to a limit of $60,000 and, to extend a measure of protection to deposits moderately above this limit, 50 percent of the amount in excess of $60,000 up to a limit of $80,000. Depositors with deposits in excess of $80,000 should be required to take full responsibility for the safety of that excess. We have created our graduated system of deposit insurance to provide for greater market discipline and to ensure that a depositor with $80,000 in deposits still receives $60,000 in reimbursement as provided by the current system. We have concluded that imposing a risk of loss only on the depositors who hold four percent of all deposit accounts containing 43 percent of all deposits will make a significant contribution to the prudent management of deposit-taking institutions without affecting in any way the financial security of the vast majority of Canadians. Accordingly, *we recommend that:*

2. Extent of Deposit Insurance Coverage

The Government of Ontario should make representations to the Government of Canada respecting deposit insurance coverage as follows:

(i) deposits under $20,000 should be fully insured by CDIC;

(ii) deposits from $20,000 to $60,000 should be insured to the extent of 75 percent of the amount exceeding $20,000 but not exceeding $60,000;

(iii) deposits from $60,000 to $80,000 should be insured to the extent of 50 percent of the amount exceeding $60,000 but not exceeding $80,000;

(iv) no deposits whatsoever should be insured to the extent that they exceed $80,000;

RRSP's and Deposit Insurance

In its written submission to us,[12] the Consumers' Association of Canada stated that it supported the $60,000 insurance maximum and that it had lobbied for the 1983 increase from $20,000 to $60,000 to protect the large deposit sums held by Canadian consumers, especially in Registered Retirement Savings Plan funds. We are sensitive to the view that RRSP's present a special case and should constitute a limited exception to the principle of coinsurance. Many individuals entrust the entire amount of their life savings to an RRSP, often well above $20,000, to provide for their retirement and the security of their spouses. We have concluded that RRSP funds which are invested in insured deposits should be covered fully up to a maximum of $60,000. Although this has the effect of making one type of retirement investment risk-free while other competing methods of saving towards retirement have no such guarantee, we believe that those who choose to commit their retirement savings to non-deposit investments are choosing deliberately to assume greater risk in the hope of gaining greater return. Subsequent recommendations which deal with the structure of compensation funds for the insurance and securities industries seek to provide some protection for those who invest RRSP funds in investments which are surrogates for deposits. Accordingly, *we recommend that:*

3. RRSP's and Deposit Insurance

The Government of Ontario should make representations to the Government of Canada that RRSP funds which are invested in insured deposit instruments remain fully insured up to the $60,000 level, with, as at present, no insurance coverage on amounts above $60,000.

Deposit Brokers

Certain financial institutions engage in a practice of paying a commission to agents ("deposit brokers") who solicit deposits for them. This practice is especially prevalent among smaller financial institutions which have, as a matter of corporate policy, decided to forego the development of a branch structure to raise retail deposits in favour of paying a commission to various agents who place wholesale deposits with them. We believe that this practice should be examined carefully to ascertain whether it may or may not be detrimental to the stability of the financial system.

We are also quite concerned about the methods of remunerating deposit brokers. Deposit brokers who are paid a high commission by a particular institution may place deposits with that institution without due regard for the interests of the depositor, the risk posed by that institution and the desirability of depositing in a number of institutions to secure maximum insurance coverage. This possibility should also be of concern to deposit insurers because it further removes the element of market discipline from the deposit-making decision. The Federal Deposit Insurance Corporation (U.S.) has highlighted the extent of deposit brokering which occurs in the U.S. and its dislocative effect on market discipline.[13] The Wyman Committee's report comments that, while the problem exists in Canada, it has not yet become as grievous as in the United States.[14]

In attempting to understand the effects of deposit brokering, we discovered that there is a

paucity of information on the subject. We consider it extremely important that deposit-insuring agencies have extensive information about these activities because of their potential ramifications for the insurance liabilities of those agencies. We also consider that these agencies are the appropriate bodies to play the front line role in monitoring deposit brokering because brokers place deposits in both federally and provincially chartered institutions. Accordingly, we believe that deposit-insuring agencies should require insured institutions to report the identity of the deposit brokers they use, the methods and rates used to remunerate deposit brokers and the percentage of their deposits which come from deposit brokers. Reports should be required at regular intervals because growing reliance upon brokered deposits and the payment of excessive remuneration may constitute early warnings of a deteriorating financial condition.

We also believe that a depositor using a deposit broker should appreciate fully the conflicts of interest inherent in the system by which deposit brokers are paid. The system of coinsurance recommended earlier in this Report makes it even more important that depositors understand these conflicts and the amount of deposit insurance coverage they are receiving. In our opinion, deposit insurance authorities should establish a system of mandatory registration for deposit brokers and, as a condition of registration, require each deposit broker to disclose to its clients whether it is receiving a commission for placing the deposit, and if it is, to disclose the amount of that commission and, for the purpose of providing a comparison, the commission rates offered by the other institutions with which it deals. A deposit broker should also be required to explain to its clients the extent to which deposit insurance is available in respect of all deposits being placed by that deposit broker.

In light of all the above considerations, *we recommend that:*

4. Deposit Brokers

a) Financial institutions which use deposit brokers to solicit deposits should be required, as a condition of retaining deposit insurance coverage, to disclose to their deposit-insuring agency the identity of such deposit brokers, the methods and rates of remuneration that they are paying and the percentage of their total deposits which have been placed by deposit brokers.

b) The deposit insurance authorities should establish a system of mandatory registration for all persons who provide deposit brokerage services. The conditions for registration should include the requirement that a registrant must disclose to its clients:

(i) whether a commission is being paid to the deposit broker by the financial institution taking the deposit;

(ii) if so, the amount of that commission and the commission rates paid by the other institutions with which the deposit broker deals;

(iii) the extent to which deposit insurance is available in respect of the deposit in question.

Institutional Depositors

This Task Force has been perturbed deeply by the fact that many publicly financed entities, such as municipalities, school boards, hospitals and universities, featured prominently among the large depositors whose funds were jeopardized in recent cases of trust company and bank insolvency. Their predicament added significantly to the pressures that led governments to override deposit insurance limits and rescue all the depositors of failed financial institutions. This predicament was

as well telling confirmation of the extent to which depositors who have no excuse for being unsophisticated have reached either directly or through deposit brokers for the highest rate of return in blind indifference to the condition of the financial institutions with which they deal and the diversity of their investments.

Not least because they derive their funds from taxes and donations, we consider that publicly funded entities should be directed to adopt prudent investment policies with respect to their assets, including most emphatically their deposits and short-term investments. With respect to all such entities that come under provincial jurisdiction, we strongly advocate that the Government of Ontario use legislation or other appropriate measures to require the adoption and regular review of investment policies designed to ensure prudent diversification of investments and deposits. Accordingly, *we recommend that:*

5. Institutional Depositors

The Government of Ontario should direct, through legislative or other appropriate measures, that municipalities, school boards, universities, hospitals, and all other institutions or agencies that are under provincial jurisdiction and whose revenue consists in whole or in part of provincial grants or tax deductible donations must adopt and regularly review investment policies that require diversification of their assets, including deposits and all other short-term instruments.

Industry Compensation Funds

The public opinion survey we commissioned for the Interim Report of the Task Force indicated that two-thirds of those surveyed believed that monies entrusted to insurance companies and their claims against these companies were insured. Many people, as well, believed that investment accounts kept at securities firms were also insured.[15] These attitudes are indicative of a more general public expectation that monies entrusted to financial institutions of all kinds will be protected in the event of an insolvency and that the state will provide assurance that these claims will be reimbursed. We have concluded that it is in the public interest to ensure consumers that they have reasonable protection against losses occasioned by the failure not only of deposit-taking institutions, but also of insurance companies and securities firms. The capital markets will operate more efficiently if this is so. Such protection is also becoming more desirable as companies design products which are an effective substitute for a deposit. We believe there is considerable merit in this protection being provided by an industry-sponsored plan.

The securities industry, through the National Contingency Fund (NCF), has provided for many years a claims fund for the customers of failed securities firms. We support the principle of this fund and comment on its adequacy later.

Both the life and property/casualty insurance industries are currently in the process of creating and implementing their own industry compensation funds. The Consumers' Association of Canada made a strong case about the need to create these funds in its written submission to us.[16] We welcome these initiatives as the past experience of the NCF shows that self-regulated industry funds provide the additional benefit of encouraging active and effective solvency regulation by the industry itself. The existence of the NCF has contributed to the adoption by industry self-regulatory bodies of stringent solvency standards and effective reporting and monitoring systems. We believe that it is of paramount importance that compensation funds be established by the insurance industry with appropriate approval from regulatory authorities. As an effective incentive for the timely implementation of these funds, we propose that no extension of the powers of life and property/casualty insurers be enacted until the funds are in place. To ensure that market discipline continues to play a role when purchasers of insurance make investment decisions, we consider that coinsurance is a desirable element of industry compensation funds. Accordingly, *we recommend that:*

6. Industry Compensation Funds

A basic principle of public policy should be to accelerate the development and implementation of industry compensation funds for the protection of individuals who have property and casualty insurance policies or life insurance policies. In pursuit of this principle, any extension of the powers of property and casualty firms, or of life insurance firms, which require legislative change should be held in abeyance until industry compensation funds that have satisfied the regulatory authorities are in place. Coinsurance features should be viewed as a desirable element of any proposed industry compensation fund.

At our public hearings [17] and in their written submission[18], the farm mutuals described the efficacy of their current industry compensation fund and argued that this fund's existence obviated any need for participation by farm mutuals in an industry-wide property/casualty insurance fund. We were impressed by the farm mutuals' description of their fund and its past record and agree that, as long as their fund has the approval of the regulatory authorities, they should not be required to participate in any other industry-wide fund to the extent of their farm mutual business.

Extra-Provincial Financial Institutions

Many of the financial institutions carrying on business in Ontario are incorporated extra-provincially. However, these institutions must be licensed by the Government of Ontario before they may operate in this province. By issuing a licence, the Government of Ontario must be deemed to bear some responsibility for Ontario residents who have deposits, acquire investments or insure with any of these institutions, and hence may be exposed to some risk of loss arising from the imprudent management of such institutions.

We addressed the consequences of this responsibility in Chapter III, noting that reliance upon the so-called equals approach remains essential for the time being. We recognize that the equals approach may raise issues of extraterritoriality and in any event places a considerable burden on Ontario regulators. However, once the industry compensation funds which we have just recommended are in place, the Government of Ontario could meet a large part of the responsibility it acquires by licensing extra-provincial institutions if it required all such institutions to be participants in the insurance or compensation fund that is relevant to their business and has been approved by the provincial regulatory authorities as offering a reasonable expectation of recovery to Ontario residents in the event of insolvency. Accordingly, *we recommend that:*

7. Licensing of Extra-Provincial Financial Institutions

It should become a condition of licensing in Ontario that a financial institution be part of an insurance or compensation fund that has been approved by provincial regulatory authorities and that, in the opinion of these regulatory authorities, offers a reasonable expectation of recovery to Ontario residents in the event of the insolvency of the institution.

Deposit Equivalents

As noted previously, the recent trend towards increased competition among different sectors of the financial services industry for a larger share of the total investment dollars of Canadians has resulted in a great deal of innovation, but also has produced a blurring of the distinctions between the products and services offered by the various sectors of the industry. There are several examples of deposit equivalents which have been created by both financial and non-financial companies:

securities firms are marketing creatively packaged free credit balances providing high daily interest rates, chequing privileges and a credit facility; life insurance companies are offering short-term annuities which are not contingent upon the life of the annuitant and which may have a term of only a few days; and retailers, through advance payments on customers' credit card balances, are offering a service that has some of the features of a deposit account at a bank, credit union or trust company.

By enacting deposit insurance schemes, governments have recognized that the savings of Canadians entrusted to deposit-taking institutions should be given a greater degree of protection than the claims of an unsecured creditor. The rationale for this policy applies to all forms of savings having the characteristics of deposits, regardless of their appellation. It would be unfortunate if the financial system is allowed to develop so that deposits called such are insured while their equivalents are not. The rapidly increasing competition for savings makes this a distinct possibility. Accordingly, we believe it is essential for the government to develop a policy as to the appropriate protection to be afforded to the functional equivalents of deposits whether these are to be offered by financial or non-financial institutions. We believe that the government should act prospectively in developing this policy rather than waiting for the issue to reach serious proportions before dealing with it. It is clear that the public is not willing to tolerate any significant risk in respect of its savings and, if for no other reason, this public expectation makes the development of such a policy imperative.

In this context, the activities of securities firms merit special comment in our view. Certain members of the industry are marketing aggressively their free credit balance accounts. While one firm has structured its account in conjunction with a chartered bank so that cash balances are insured by Canada Deposit Insurance Corporation, other accounts are backstopped only by the National Contingency Fund. The potential growth of these new accounts is tremendous (although there is currently some consumer lethargy about their acceptance) and we believe that the Government of Ontario should review the adequacy of the NCF within the context of this potential growth. The testimony of one representative of the Securities Industry Capital Markets Committee before our public hearings shows that our concern about the adequacy of the NCF to cover these new accounts is shared by industry members.[19] In light of all of the above considerations, *we recommend that:*

8. Deposit Equivalents

The Government of Ontario should undertake to examine contractual arrangements equivalent to deposits which are being developed by financial and non-financial enterprises to determine whether these new methods of accumulating savings should receive the same protection afforded to traditional deposit instruments. This examination should include a review of the adequacy of the securities industry's National Contingency Fund with particular attention to the growth in the size of free credit balances held with securities firms.

The Role of Canada Deposit Insurance Corporation

Canada Deposit Insurance Corporation, which is a federally incorporated and regulated organization, is authorized to insure the deposits of banks, trust companies and loan companies carrying on business in Ontario. The chartering of banks is the exclusive preserve of the federal government, while insured trust and loan companies may be incorporated either federally or provincially. Pursuant to the draft provisions of the *Loan and Trust Corporations Act* (the "Draft Act"), coverage by CDIC will be a requirement of incorporation in Ontario. CDIC is not involved currently in the regulation and supervision of member institutions; these roles in general are performed by the regulator in the jurisdiction in which the insured institution was incorporated.

The Wyman Committee report recommended that CDIC acquire powers to allow it to become more actively involved in the regulation and supervision of its members.[20] In making this recom-

mendation the Wyman Committee commented favourably on the powers of the Federal Deposit Insurance Corporation which actively regulates and supervises financial institutions, both state and federally incorporated, in the United States.[21] Notwithstanding the U.S. experience, we consider that the Wyman Committee's recommendation of this expanded role for CDIC overlooks the continuing responsibility of provincial governments for regulating the deposit-taking institutions under their jurisdiction. We are also most concerned to avoid any unnecessary duplication of regulation that would incur unjustifiable cost to the consumer and the taxpayer. We recognize as well that CDIC has significant exposure for insured loan and trust corporations which are provincially chartered.

Several submissions,[22] both oral and written, advanced the need for better harmonization of federal and provincial regulation. The Canadian Bankers' Association, in particular, commented on the Wyman Committee's proposal to give expanded regulatory and supervisory powers to CDIC. The CBA felt that CDIC should not become involved in regulation or supervision, being especially concerned about the costs of duplicated efforts. As an alternative, the CBA stated that CDIC should work closely with the regulators to establish uniform regulatory standards. CDIC, if concerned about the solvency or practices of a member institution, should work with the regulator to structure an appropriate response, always having the power to withdraw deposit insurance to ensure that its concerns are heard by the regulator.

We fully endorse a non-duplicative approach to regulation in a framework that will facilitate and encourage effective co-operation. The interests of federal regulatory authorities, provincial regulatory authorities and CDIC are common: to ensure a solvent and vigorous financial industry through sound regulation. We do not advocate transferring any of the functions performed by the present regulatory authorities to CDIC but we do discern a role for CDIC beyond the provision of insurance coverage. We have recommended already in this chapter that CDIC should register deposit brokers and receive information from deposit-taking institutions on their use of deposit brokers. This information should be shared with both federal and provincial regulatory authorities. We favour a formal federal-provincial agreement which would delineate the respective roles of federal regulators, provincial regulators and CDIC, and establish clear obligations on all parties to exchange information among themselves.

We discern as well that the corporate board of CDIC could play a vital role in pooling the information, experience and perspectives of the key constituencies involved in promoting the solvency of deposit-taking institutions. As currently constituted, the board of directors of CDIC is comprised of the persons holding the federal offices of the Governor of the Bank of Canada, the Deputy Minister of Finance, the Superintendent of Insurance and the Inspector General of Banks as well as a private sector chairman appointed by the Governor in Council, on the recommendation of the Minister of Finance. In submissions to us, the CBA and the Trust Companies Association of Canada both argued for industry representation on the board of directors of CDIC.[23] In fact, the Wyman Committee's report has recommended that three further private sector directors be appointed to the board.[24] We endorse private sector directors for CDIC because industry perspectives concerning emerging trends and practices in the financial community are of enormous assistance in discerning changing risk patterns among deposit-taking institutions. The remaining constituency that should be represented on the CDIC board is that of provincial trust and loan company regulators. We consider it most advisable that the Government of Ontario should make representations to the Government of Canada requesting that at least three positions on the CDIC board be allocated to individuals having regulatory responsibility for provincially chartered loan and trust companies. It should be clearly understood that the actual appointment of the provincial regulators, like that of the industry representatives, would be the prerogative of the Governor in Council. A CDIC board whose membership includes federal, provincial and industry representatives has major potential for fostering effective regulation, eliminating unnecessary duplication and sharing information. In light of these considerations, *we recommend that:*

9. CDIC Supervisory Functions

a) **A formal federal-provincial agreement should be developed pursuant to which the federal regulatory authorities would be primarily responsible for regulating and supervising federally chartered financial institutions, the provincial regulatory authorities would be primarily responsible for regulating and supervising provincially chartered institutions, and both sets of regulatory authorities would have similar obligations to disclose and exchange information, including information as to any inordinate risks being assumed by such institutions between themselves and with Canada Deposit Insurance Corporation (CDIC).**

b) **The Government of Ontario should make representations to the Government of Canada requesting that at least three persons having regulatory responsibilities in respect of provincially chartered trust and loan companies be selected to sit on the board of CDIC.**

Chapter V

Financial Institutions: Their Ownership, Internal Practices and Investment Powers

The Ownership of Financial Institutions

The purpose of this chapter is to develop the principles relating to ownership, internal practices and investment powers that the Task Force believes should apply generally throughout the financial services industry. We have considered the ownership of securities firms separately in Chapter X so that our discussion here deals only with the ownership of financial intermediaries.

Many of the submissions made to the Task Force related to the question of whether financial institutions should be widely or closely held. The evidence given during our public hearings and the increasing prevalence of closely-held financial institutions has caused us mounting concern about ownership issues in the course of our deliberations.

At one level, this concern is rooted in the association between closely-held ownership and self-dealing. As we pointed out in Chapter II of this Report, as many as one half of the failures or near failures of Canadian financial institutions since 1980 may be attributed to the fraud or self-dealing of the owners of those institutions. It was because of our concern over self-dealing that in our Interim Report we felt called upon to recommend stringent prohibitions against this practice. As noted earlier, the terms of deposit insurance coverage and high leverage mean that shareholders of deposit-taking institutions in particular have a strong incentive to take risks, which may be harmful to the institution if they prove unjustified. Closely-held ownership accelerates this risk by providing an environment in which depositors' interests, managerial interests and the interests of minority shareholders can be subordinated easily to the interests of the dominant shareholder and greatly increases the risk of self-dealing.

The Task Force recognizes that a closely-held financial institution can be managed efficiently and successfully. There are certainly examples where controlling shareholders have been a beneficent force requiring excellent management and a high standard of conduct. Nevertheless, experience shows that controlling shareholders may also subvert the purposes of a financial institution, using its resources as though these were their own. Experience has shown that controlling shareholders all too frequently have disposed fraudulently of the assets of the institutions that they controlled. The Task Force also recognizes that widely-held institutions are not insulated from practices that lead to failure, as the recent Canadian bank failures sadly indicate, but it remains clear that closely-held institutions are particularly vulnerable to unscrupulous and questionable practices.

However, insolvency is not the only danger arising in closely-held institutions; their efficiency is at stake. Such institutions can, and frequently do, enter into transactions with the controlling shareholders, or with interests associated with them, which are not fraudulent in their nature. In such circumstances the management may be tempted to bargain less resolutely with its controlling shareholder than it would in an arm's length transaction. The best assurance that a corporation is acting to advance its own interest is for it to be managed by managers who are acting at arm's length

from those with whom they do business. Indeed, the benchmark of an arm's length transaction is a universally recognized criterion of market value. When transactions are entered into between an institution and its controlling shareholder, steps are often taken to ensure that the result is equivalent to what would have been attained in an arm's length transaction. Sometimes such transactions are submitted for approval to a committee of independent directors. No matter how vigorously this ideal is pursued the measures taken must always be regarded as a second-best alternative because the persons making the judgment can never be sure that the management is as aggressive in pursuit of the financial institution's objectives as it would be if it were not bargaining with the controlling shareholder. Obviously, an even greater danger exists where the controlling shareholder has caused directors to be appointed who are independent in name only. As one witness said pliant directors may be found who will serve as independent directors, but who will be very conscious of the wishes of the controlling shareholder.[1]

These dangers, we hope, can be avoided by the strictest possible controls on self-dealing to limit the transactions between financial institutions and their controlling shareholders to situations where a market value is readily available. However, there can be no doubt that even the strictest regulation will never provide the assurance given by an arm's length transaction. In the end, assurance that self-dealing will not arise in situations of closely-held ownership requires a belief in the integrity of controlling owners and in the capacity of regulators to enforce self-dealing prohibitions. The evidence is more than sufficient to convince us that these beliefs rest on unsafe foundations as not all controlling owners have acted honestly and regulators have not always been able to ascertain the real nature and effect of some transactions. While we have lost none of our ardour for self-dealing prohibitions, we have been led to consider the extent to which such prohibitions constitute a second-best solution, second best because it would have been preferable to prohibit closely-held ownership in the first place.

Self-dealing considerations aside, we, like a number of other observers, have been concerned with the prevalence of closely-held ownership at a second level. We refer to the ongoing developments whereby financial institutions have become affiliated with conglomerates whose holdings are a mixture of real, that is commercial, and financial enterprises.

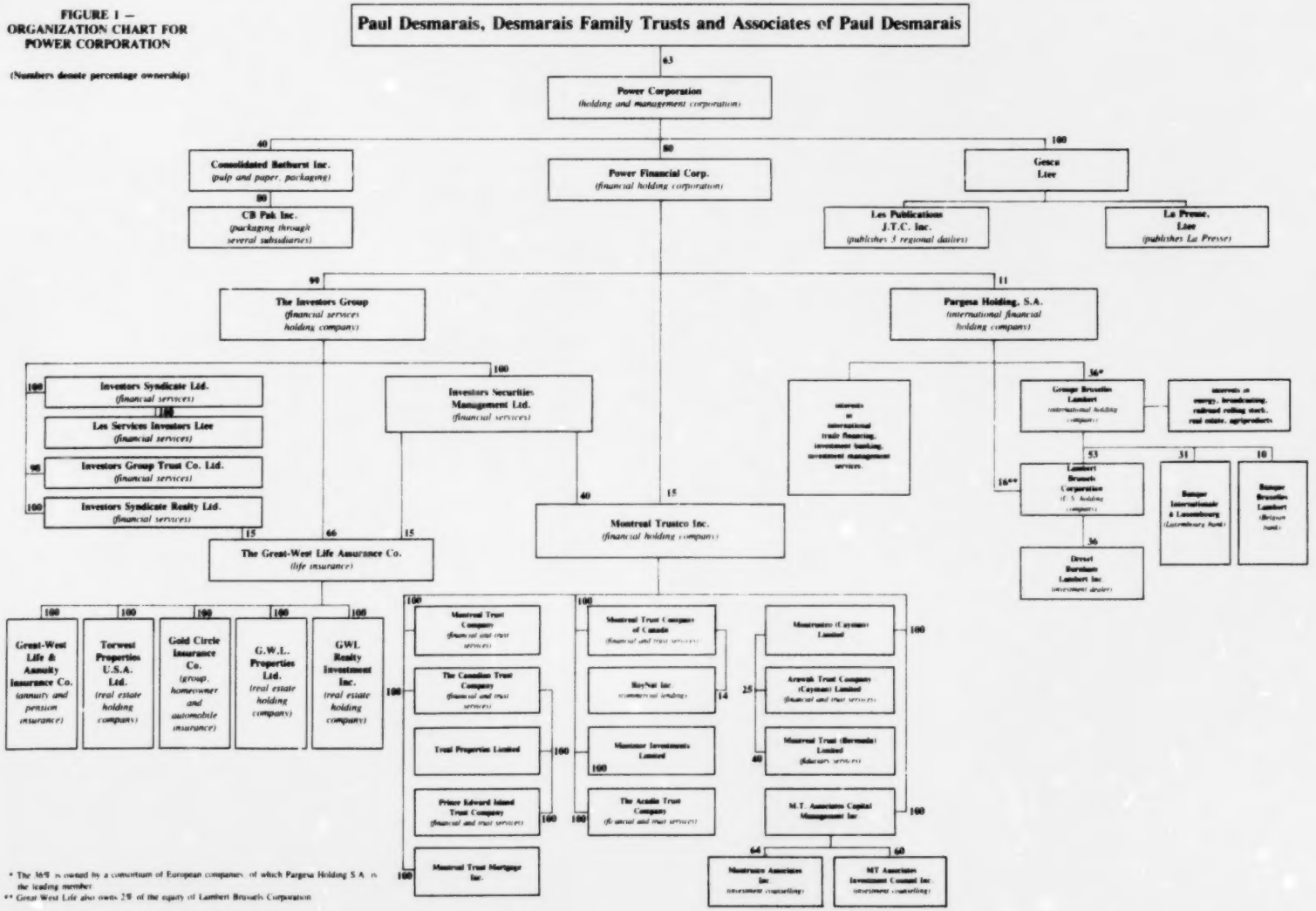
For many years there has been an almost complete division in North America between the real and financial sectors of the economy. The system is in marked contrast to that prevailing in some countries in Europe and in Japan where the financial institutions that serve as intermediaries between the savers of capital and the users of capital have had very close associations with the users. The Task Force believes that the existing system has served Canada well, developing as it has a very efficient capital market. The system imposes a discipline on the users of capital because they must satisfy the financial intermediaries of the feasibility of the purpose for which they seek funds. It is the view of the Task Force that this desirable distinction will be best maintained if financial institutions are not under the control of those who are heavily involved in the real sectors of the economy.

The Task Force is also concerned about the possibility of significant concentration in the ownership of financial institutions. Some of the submissions made by users of the system reflected a concern that the sources of financing might fall into too few hands. In our view, confidence in the fairness of the system is more likely to be attained by a diversification of the ownership of the system than by concentration. As the organizational charts of Power Corporation and Edper Investments Ltd. reproduced herein indicate, the recent growth of financial holding companies has brought about an unprecedented conglomeration of ownership in the Canadian financial services industry.

The Task Force does not believe there is any compelling need to encourage the development of closely-held institutions to secure an efficient system permitting Canadian institutions to compete effectively at home and abroad. Canada has been able to develop a very effective banking system which is very widely held, yet has clearly been able to obtain the financing and management required to operate effectively in Canada and elsewhere.

FIGURE 1 — ORGANIZATION CHART FOR POWER CORPORATION

(Numbers denote percentage ownership)

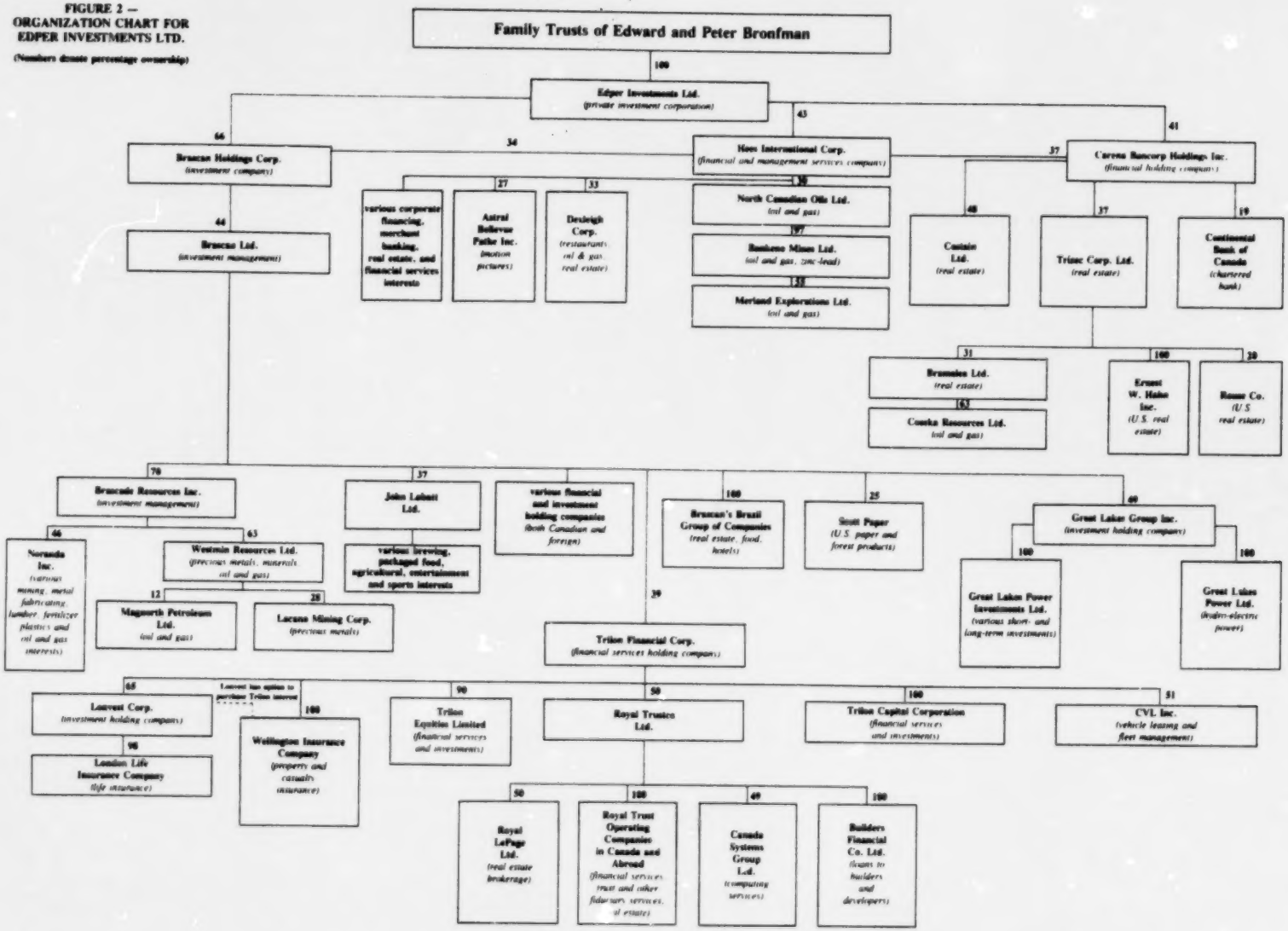


* The MVS is owned by a consortium of European companies, of which Pargesa Holding S.A. is the leading member.

** Great-West Life also owns 2% of the equity of Lambert Brussels Corporation.

FIGURE 2 — ORGANIZATION CHART FOR EDPER INVESTMENTS LTD.

(Numbers denote percentage ownership)



It seems self-evident that the financial institutions entrusted with the savings of Canadians should be managed with the primary objective of achieving the best possible results for the financial institutions and their customers. Because of the threat to solvency posed by self-dealing in closely-held institutions and because of the potentially undesirable concentration of power evident in the development of conglomerates, the Task Force believes that, on balance, this objective is more likely to be achieved by widely-held than closely-held institutions. Thus we have concluded that the bias of public policy should be in favour of having financial institutions widely held. Accordingly, *we recommend that:*

1. Widely-Held Ownership as a Policy Principle

A basic principle of public policy should be to encourage the development of widely-held, rather than closely-held, financial institutions.

The Task Force acknowledges that this goal cannot be quickly attained, having regard to the many institutions that are now closely held. Nonetheless, the principle can and should be pursued in a way directed to avoiding any further concentration of ownership and to maintaining and enlarging the widely-held sector of the Canadian financial system. The Task Force has rejected the alternative of forced immediate divestiture, believing that the disruption arising from a requirement of this type would be excessive. However, a gradual change could be effected as the ownership of these institutions changes from time to time and as new entrants seek approval to engage in the financial services business.

In our view, pursuing the principle in practice requires that, whenever an application is made for approval of a new charter or a change in control, preference should be given to the acquisition of control by a widely-held corporation. Approval should only be given to applications by closely-held businesses when there is a clearly perceived need for new participation in the industry. A major consideration in granting approval should be whether the applicant has plans to increase public participation with a view to becoming widely held.

Furthermore, the pursuit of the principle of widely-held ownership should make policy-makers particularly wary of ownership patterns that have caused financial institutions to become affiliated with conglomerates whose holdings are a mixture of commercial and financial enterprises. When approval is sought for changes in ownership or for the right to carry on a financial business, the regulatory authorities should favour applications by widely-held institutions that intend to confine their business activities to financial businesses. The involvement of such an applicant in businesses other than the financial business should be regarded as a major impediment to a successful application. Accordingly, *we recommend that:*

2. Approval of New Entrants and of Changes in Ownership and Control

In line with a policy to encourage the development of widely-held institutions, the regulatory authorities should:

(i) favour, when approval is sought for new charters or for changes in ownership and control, applications by widely-held institutions that intend to confine their activities to the financial business;

(ii) refrain from approving the creation of closely-held institutions unless there is evident need for new entrants to a financial services market and the closely-held applicant has clear plans to increase public participation with a view to becoming widely held.

The objective of increasing widely-held ownership of financial institutions is not consistent with measures that would result in further additions to the existing numbers of closely-held institutions on any other levels. The Task Force has considered the recent federal proposals to permit closely-held banks and does not agree with or support them. The so-called Green Paper puts forth the concept of a new category of Canadian-owned banks, Schedule C banks, which would be permitted to be closely held by a financial holding company.[2] Under the current federal *Bank Act*, no single shareholder may own more than ten percent of a Schedule A bank, except during an early development phase. As a result, the major banks in Canada are now widely held in contrast to other financial institutions which have no limitations on individual domestic ownership. We are concerned that, apart from banks, much of the Canadian financial system is rapidly becoming dominated by a small group of corporations and individuals. In our view, the existing banking laws provide a necessary and desirable diversification of the financial system, without which the trend towards concentration of ownership would be virtually unchecked. We consider that the current federal proposals represent a major departure from the spirit of existing banking legislation which is in line with our advocated policy of encouraging a widely-held financial industry. Accordingly, *we recommend that:*

3. Banks as Widely-Held Institutions

The Government of Ontario should communicate to the Government of Canada that it strongly endorses the current federal legislation requiring that domestically-owned banks be widely-held institutions and that exemptions from this requirement should not be permitted.

We have been interested and encouraged by some other aspects of the federal Green Paper, however. The existing regulatory system in Canada has not taken into account the increasing presence and growth of conglomerates in the financial services industry in recent years. As a result, these operate in an essentially unregulated environment at the level of the holding company. We agree with the principle, expressed in the federal discussion paper, that conglomerates with ownership interests in the financial industry should be brought within the financial regulatory system. The importance of regulatory mechanisms to ensure the solvency of participants in this industry extends to those companies that own financial institutions as well as to the institutions themselves. When the parent or holding company has interests in more than one financial institution, and these are subject to different legislative regimes, the importance of having regulatory mechanisms in place is even more crucial. Clearly the movement of capital among various commonly-held institutions may be critical to the solvency of any one affiliate or, indeed, given the extent of the holdings of some conglomerates, to the preservation of confidence in the system as a whole.

Ownership links in the financial services sector demand that some consistent structure be developed so that where different types of financial institutions are regulated under different statutes, their common ownership is subject to a regulatory authority. In our view, the most appropriate means of meeting this objective is through the licensing and regulation of financial holding companies. There may be worthwhile alternatives to regulating the holding company structure which achieve the same objective but none has been brought to the attention of this Task Force. Whatever the form of regulation, and we prefer the financial holding company structure, it is apparent that immediate attention

should be given to regulating these ownership links in the financial services industry before greater degrees of conglomeration develop. We do not agree with the proposal to exclude Schedule A banks from access to the financial holding company structure because this would discriminate against the key widely-held segment of the Canadian financial system. Accordingly, *we recommend that:*

4. Financial Holding Companies as Public Policy

It should be a principle of public policy that ownership links between financial institutions operating under different legislation should be permitted only through a financial holding company, and that the financial holding company device should be made available to domestically-owned banks as well as to other types of financial institutions.

We consider it most important that there be consistency in the federal and provincial approaches to the regulation of ownership links in the financial services industry. Financial institutions and their holding companies should be properly regulated by the responsible jurisdiction. Ontario's authority over the operation of certain financial institutions in this province imposes a responsibility to the Ontario public to regulate Ontario financial holding companies with ownership interests in these institutions. The possibility of such regulation was foreseen in the 1983 Ontario White Paper[3] on the *Loan and Trust Corporations Act* and the advent of similar legislation at the federal level argues for provincial entry to the field now to ensure consistency of regulatory systems at both levels of government.

It is our considered opinion that the requirement for a provincial holding company should be triggered by the occurrence of an ownership level of more than ten percent. Where an individual or corporation has acquired a greater than ten percent equity interest in any provincially-chartered financial institution and also has ownership interests to the same extent in any other financial institution regulated under different legislation, a provincial financial holding company should be mandatory.

The only exception to this rule should be the ownership of a securities firm. Here different considerations, discussed in Chapter X, apply.

The requirement of an Ontario financial holding company should apply, furthermore, not only where the relevant financial institution is incorporated in Ontario but also where any provincially-chartered institution is carrying on business in this province. Accordingly, *we recommend that:*

5. Provincial Financial Holding Companies

The Government of Ontario should prepare provincial legislation which will impose a financial holding company requirement with respect to commonly-held financial institutions that are operating under different legislation and are provincially chartered.

Whether the current federal discussion paper proposals become law or some other form of regulation of conglomerates is devised by the federal government, the relevant regulatory mechanisms should be common to both jurisdictions. We favour the financial holding company approach, but, if this is not adopted, we favour an approach which is common to the federal and provincial authorities. If the provincial policy were to differ significantly from federal policy on financial holding companies, it would only add further confusion to the Canadian regulatory environment.

We have considered the various aspects of regulation to which financial holding companies should be subjected. For its part, the federal Green Paper outlined a number of principles that should be adopted in determining the powers and regulation of holding companies. We are in general agree-

ment with the direction taken by these proposals. In addition, there are a number of other areas that require specific action.

With respect to the sources of funding of financial holding companies, it is essential to the solvency of these enterprises that the source and integrity of initial capital should be determined at the outset. During subsequent supervision of these businesses, changes in the source of funding should be traced and assessed carefully together with any changes in the quality of the original capital source.

The relationship between the holding company and its affiliated financial institutions requires strict regulation. Affiliated as used in this chapter means the same ten percent test which we recommend should trigger the financial holding company requirement. Financial institutions should not be permitted to own equity in the holding company and the transfer of funds among institutions under the same holding company should be subject to clear regulatory controls. Similarly, restrictions on the proportion of shares held by a specific party should be applied on a consolidated basis to the holding company as well as to the financial institutions with which it is affiliated.

When a financial holding company is affiliated with a commercial as distinct from a financial firm, there also should be a prohibition on transactions between that commercial firm and any affiliated financial institution.

We would also propose to tighten further the restrictions on cross-directorships set out in the Green Paper, which suggest that affiliated financial institutions could have up to 25 percent of these directors serving on more than one board. Under those restrictions, a significant shareholder or a control group of a financial holding company could be directly involved in each of the affiliated companies, leading to a potential for conflicts of interest and a lack of independence on the part of the affiliates. In order to contribute to the independence of companies within a holding company which are competing with one another, we propose that no one director of a financial institution be allowed to sit on the board of any other financial institution unless one is a subsidiary of the other. No director of a financial institution should be allowed to serve as a director of an affiliated financial institution when those institutions are competing with one another in any facet of their businesses. Thus, a director of a trust company would not be permitted to sit on the board of an affiliated insurance company when they were both engaged in the mortgage business or in providing what are, effectively, deposit instruments. We propose that up to one-third of the directors of the holding company be permitted to serve on the boards of its affiliated financial institutions.

Many of the other general principles that we have recommended throughout this Report should be extended, *mutatis mutandis*, to financial holding companies. Particular concern should be had, for example, to develop strict self-dealing and conflict of interest rules according to the policy considerations we have formulated in this Report.

These issues should be discussed extensively in the developmental sessions which we propose take place between federal and provincial authorities. The fullest consultation at the policy, planning and drafting stages of the process will ensure consistent legislation and subsequent consistent administration. Accordingly, *we recommend that:*

6. Provisions of Financial Holding Company Legislation

Through its own initiatives and in consultation with the Government of Canada, the Government of Ontario should strive to secure the enactment of legislation whereby federal and provincial financial holding company legislation will contain similar provisions with respect to the following:

(i) standards governing the formation of financial holding companies that scrutinize the source and integrity of their financing, prohibit financial institutions from holding equity in their holding company, regulate the transfer of funds among

institutions under the same holding company, and ensure that any applicable restrictions on the proportion of shares held by a specific party will apply on a consolidated basis to the financial holding company as well as to the financial institutions with which it is affiliated;

(ii) supervision of established financial holding companies that will ensure continued adherence to the standards governing their formation, require approval of any transfer of ownership or change in control, and favour, in the granting of such approval, a widely-held over a closely-held applicant;

(iii) restrictions on cross-directorships that will stipulate that where a group of financial institutions are affiliated with a financial holding company: (1) a director of one financial institution shall not be a director of another financial institution except where one financial institution is a subsidiary of the other, and (2) no more than one-third of the directors of the financial holding company may be directors of its affiliated financial institutions.

The Internal Practices of Financial Institutions

We have discussed elsewhere in this Report the public policy considerations dictating that the solvency of financial institutions must be protected more carefully than the solvency of non-financial corporations. These considerations include the importance of consumer confidence in the stability of the financial system and the possible macro-economic consequences of the failure of a financial institution. Consequently, government has a significant interest in the viability of financial institutions and this justifies measures designed to police closely the stability of financial institutions. However, compliance with these protective measures is monitored by government regulators, who, by definition, must carry out their regulatory function from a vantage point external to the financial institution. Therefore, they are not always in a position to notice and correct the practices of a financial institution that may have an adverse effect upon the financial stability of the institution. Moreover, recent experience demonstrates that the regulators have all too often become aware of problems when it is too late to revive the financial institution without drastic action, if at all.

The Task Force is of the view that the first line of defence of the solvency of financial institutions must come from within the financial institution itself. However, in the course of our proceedings we have heard evidence from a great many industry participants who have lamented the neglect of duties of some directors of financial institutions who are not fulfilling their role of monitoring the management of the institution. Courts are very loath to substitute their business judgment for that of directors, recognizing the dangers of applying hindsight to an evaluation of any decision. In many respects this is a salutary and reasonable approach, but its existence makes it very important that there be some well-established benchmarks as to how this judgment should be exercised. This is particularly important in the case of financial institutions where a failure can have such far-reaching consequences. Accordingly, the Task Force believes that there should be more specific rules setting out the responsibility of directors of a financial institution for monitoring the financial condition of the institution.

The Task Force thinks that the primary internal role should be assumed by an audit committee charged by statute with the responsibility of assessing the financial condition of the institution.

The directors, of course, would bear the ultimate responsibility and would need to assure themselves that the audit committee was carrying out the function in an effective manner. Such a system would permit boards of directors to be much better informed than has been the case in the past in all too many situations and should permit them to take steps to spot potential problems so that the financial stability of the institution may be preserved.

The audit committee should be made up of outside directors, thus allowing the committee to carry out its functions impartially. If, for example, the chief executive officer of the financial institution is a member of the audit committee, the committee may be dominated by that officer in such a way as to undermine seriously its independence.

Although requirements for audit committees have existed for some time in respect of public corporations, certain Ontario statutes governing financial institutions currently do not require the formation of an audit committee. In our view, all financial institutions should be required by statute to have audit committees.

The existing statutes that do require the formation of an audit committee are not entirely clear as to the role to be played by this committee. The rationale for the audit committee was stated by the Select Committee on Company Law (Ontario, 1967) in terms of insulating the auditor from the pressure of management by providing a forum where the auditor could discuss freely any matters relevant to the audit duties.[4] Generally speaking, the statutes only require the audit committee to review the financial statements of the corporation and report thereon to the board of directors before they are approved.

In practice, an audit committee may perform functions beyond its statutory duty but this is not mandatory. Thus, the actual role performed by the audit committee will vary greatly from institution to institution and will depend in part upon the diligence of the individual members. Aside from providing a direct line of communication between the auditor and the directors, the audit committee can improve the board's supervision of management and help better inform the board of directors of the institution's financial condition through independent access to financial information and contact with the auditor. An audit committee may also, in the course of its enquiries, discover instances of self-dealing, suspected fraud and other irregularities. Thus, certain audit committees choose to fulfil a role going beyond their statutory duty to review the financial statements and undertake to monitor the stability of the financial institution, but they are not required to do so.

The monitoring function of the boards of directors of financial institutions should be enhanced by imposing a duty on their audit committees to take such steps as are reasonably prudent to assess the financial stability of the financial institution. Under such a regime, the audit committee would be required to obtain and review information respecting any aspects of the business or operations of the institution that would reasonably be expected to have an impact upon the financial position of the institution. The committee would seek out this information not only from the auditor but from the internal accounting staff and management of the financial institution. Although this imposes a broad duty upon the audit committee, we believe that an aggressive audit committee can search out and help correct practices or conditions that may threaten the viability of the financial institution. Problems may be faced candidly and their resolution handled in the boardroom of the financial institution rather than by governments and regulators.

Although the main goal of the Task Force in respect of audit committees is the protection of solvency, our recommendations involve legislating a role for the audit committee similar to that currently being carried out by effective and diligent audit committees; therefore an expanded role for the audit committee may also improve the profitability of the financial institution. Accordingly, *we recommend that:*

7. Audit Committees: Statutory Requirements

The statutes governing Ontario financial institutions should be amended to require the directors of all such institutions to appoint an audit committee composed entirely of outside directors, and to impose a general duty upon the audit committee of a financial institution to take such steps as are reasonably prudent to assess the financial stability of the financial institution and to obtain and review any information necessary to this assessment.

In view of the general nature of the duty set out in this recommendation, we believe that it is also important for the Lieutenant Governor in Council to specify by regulation certain matters, beyond the traditional role of reviewing and reporting upon the financial statements, that should be addressed by the audit committees of financial institutions. It must be stressed that by setting out this list, we do not intend that the audit committee be absolved in any way of its responsibility to take steps beyond those listed in the regulations in carrying out its duty to assess the financial condition of the institution. In view of the rapidly changing nature of the financial industry, we believe that the government should review regularly these regulations so that they may be appropriate to the circumstances of the time.

We were informed during the hearings that audit committees do not always interview the auditors at their meetings. Consequently, this should be required by regulation.

Recent failures of financial institutions have demonstrated the degree to which questionable accounting practices may disguise serious problems in the affairs of a financial institution. Accordingly, the regulations should require the audit committee to review annually management's methods for making provision for loan loss reserves, appraising real estate and dealing with doubtful accounts. An audit committee carrying out its responsibility to express an opinion on the financial statements of an institution should, of course, consider carefully the accounting practices of the institution used in the preparation of such statements and report its findings to the board.

In the course of our hearings, we became aware that the concept of materiality kept many instances of suspected fraud, misfeasance or other financial irregularities, self-dealing, and transactions apparently outside of the powers of the financial institution from coming to the attention of the audit committee. In our view it should be a requirement that every example of such practices discovered by the auditor in the ordinary course of the audit or in any other way be brought to the attention of the audit committee. This would allow the audit committee to determine how it proposes to deal with these practices and to determine whether these practices, when considered in their totality, are symptomatic of larger problems requiring eradication by the board of directors. The responsibility of determining materiality with respect to these matters should be removed from the auditor.

Consistent with its duty to take such steps as are reasonably prudent to assess the stability of the financial institution and to obtain any information necessary to this assessment, we believe that the audit committee should take the responsibility of establishing an internal control mechanism designed to expose instances of self-dealing and conflicts of interest. Such a mechanism is necessary because many instances of these practices may not be discovered by the auditor in the ordinary course of the audit. The internal control mechanism should involve the audit committee with the firm's own management accountants, and rely on informal as well as formal channels of information in searching out and reviewing instances of conflict of interest and self-dealing.

More generally, the Task Force believes that directors and regulators must take much more effective steps than in the past to avoid insolvencies. In this connection, we attach great importance to the development of early warning systems designed to monitor the risk exposure of financial in-

stitutions. In Chapter III of this Report, we recommend measures which will require each regulatory authority to develop a system appropriate to the institutions under its mandate, and which will impose a statutory duty on the institutions themselves to assemble and transmit the necessary data. The regulatory authorities will need time and the assistance of the industry to develop efficacious early warning systems. Pending their implementation, it should be incumbent on each financial institution to develop its own early warning system, and a clear obligation to implement such a system should be imposed on every audit committee.

The audit committee of a financial institution, in carrying out the duties we prescribe, will generate valuable information respecting the financial stability of the institution and may unearth evidence of conditions and practices that need to be corrected. However, this will not serve any useful purpose unless the findings of the audit committee are communicated in a full and frank manner to those who have the responsibility for acting upon them. For this reason, we are of the view that each member of the board of directors of the financial institution and the relevant regulator should be sent promptly copies of the full minutes of audit committee meetings. The minutes should fully reflect the proceedings of such meetings. This would ensure that the other board members and the regulator are kept fully aware of the financial status of the institution on an ongoing basis, so that they may take appropriate action to correct any problems discovered by the audit committee before they result in an insolvency. During the public consultation process of the Task Force, the Institute of Chartered Accountants of Ontario (ICAO) expressed the concern that when everything gets reported to the regulators the reports may tend to become 'sanitized'.[5] For this reason, the ICAO argued that only 'material' information should be communicated to the regulatory authorities. We disagree with this view. In fact, if the assertion is true that minutes of meetings will be 'sanitized' before being sent to the regulator, in our opinion this argues all the more strongly that regulation is important in this area. The requirement to disclose the proceedings of audit committee meetings should not provide simply for the transmission of meeting minutes but should impose an obligation to take complete minutes that accurately and fully reflect the proceedings. We take cognizance of the ICAO caveat and, for this reason, believe that a duty to disclose fully is an essential component of the prescribed regulations. To ensure that all of the considerations discussed are dealt with by the audit committee of each financial institution, *we recommend that:*

8. Audit Committees: Authority to Make Regulations

Without limiting the generality of the duty imposed in the preceding recommendation, the Lieutenant Governor in Council should be given the power to make regulations setting out specific matters that audit committees must consider in their deliberations and to require that they make reports to the full board of directors on their findings. These regulations should specify that the audit committee must:

(i) interview the auditors of the financial institution at least once per year;

(ii) review annually the financial institution's methods of asset valuation and, in particular, the method for appraising real estate;

(iii) review annually the financial institution's method for dealing with doubtful accounts including the method for establishing the reserve for losses;

(iv) review annually the extent and nature of any obligations of the financial institution which constitute off balance sheet items;

(v) ensure that the institution has an adequate system in place to discover instances of self-dealing and to ensure that the provisions of the legislation governing the financial institution as to self-dealing and conflict of interest are observed;

(vi) review every instance of self-dealing, regardless of its materiality;

(vii) review any instances of suspected fraud, misfeasance or other irregularity, regardless of their materiality;

(viii) review any transactions of the institution that appear to be outside the powers of the financial institution;

(ix) establish an early warning system to monitor the level of risk exposure of the financial institution;

(x) have minutes taken of every audit committee meeting that accurately and fully reflect the proceedings and send promptly copies of these minutes to every director of the financial institution and to the relevant provincial regulator;

(xi) meet at least four times per year.

To ensure that the audit committee is informed of instances of self-dealing, fraud, misfeasance and other financial irregularities, and transactions that are apparently beyond the powers of the institution, regardless of their materiality, we believe that the auditor must be given a statutory duty to report these matters to the audit committee promptly. Similarly, one of the principal purposes of an audit committee is to establish a direct line of communication between the auditor and the non-management directors. To facilitate this function, the auditor of a financial institution must have sufficient access to the audit committee and the opportunity to make representations to the committee. Accordingly, *we recommend that:*

9. Statutory Duties of Auditors

The statutes governing the regulation of financial institutions in Ontario should be amended to require the auditor of a financial institution to attend all meetings of the audit committee, to make such reports on the work conducted by the auditor in its capacity as such, or on behalf of the institution, as the auditor deems desirable to assess the financial stability of such institution, and in particular to report to the audit committee every instance of:

(i) self-dealing;

(ii) apparent fraud, misfeasance or other financial irregularity;

(iii) transactions apparently beyond the powers of the institution;

(iv) any transaction that could have an adverse effect on the financial stability of such an institution;

(v) any transaction involving a liability of the financial institution which would constitute an off balance sheet item,

which is discovered in the ordinary course of the audit.

Investment Powers

The long-standing statutory regulations known as the 'legal list' or 'legal for life' restrictions on investment by financial institutions have been the subject of a great deal of debate in recent years, on the one hand by those who argue that these restrictions are outdated and misleading and, on the other hand, by those who argue that they provide appropriate guidelines as to what constitutes safe investments.

The restrictions currently in place for insurance and trust and loan companies, among others, are based on similar principles and have generally similar provisions. Their object is to ensure that financial institutions do not take excessive risks in the investment decisions that are essential to the financial intermediation function. These statutory restraints require those responsible for the investment of funds to restrict the placement of funds to investments authorized by the legislature. Authorized investments are known as the legal list. Quality tests, which require a specific record of dividend payments, interest coverage or earnings criteria, are applied to determine the investment status of corporate bonds and shares.

Essentially the investment rules authorize certain categories of investments, such as mortgages, bonds, debentures and shares of other corporations. The rules also provide limits on the amount that may be invested in each of the authorized categories. Finally, the rules provide tests designed to restrict the placement of funds in the authorized categories to certain quality investments. The quality tests provide, for example, that before an institution can invest in the common shares of another corporation, those shares must have either paid a dividend for the preceding five years or have had earnings sufficient to pay dividends during that period.

Various submissions to the Task Force addressed the existing investment rules and suggested proposed investment rules, including the option of imposing a duty on institutions themselves to adopt a prudent investment approach with responsibility for ensuring the quality of their own investment decisions, but without the restraints of a legal list. The Canadian Life and Health Insurance Association indicated that they favour replacement of the legal list approach with a prudent management approach featuring a broad general power with respect to investments in order better to enable institutions to match assets and liabilities.[6] Professor Seymour Friedland stated that many of the legal list restrictions "make little sense in that they don't take advantage of many things that we have learned in the last 40 or 50 years."[7] The Trust Companies Association of Canada also emphasized the need for greater flexibility in the regulatory framework allowing portfolio investments by institutions.[8] Finally, the Canadian Bar Association-Ontario (Special Committee) was of the view that the legal list is antiquated and fails to respond to opportunities afforded by modern investment vehicles.[9]

Indeed, severe legal list restraints may be costly to the goal of optimum capital investment and are imprecisely related to their principal objective of ensuring institutional solvency. They may mislead people to think that the quality of an investment is better than it, in fact, may be and they may relieve management of some of its responsibility to ensure prudence in investment decisions. Finally, as the federal Green Paper points out, they fail to focus attention "on the areas that carry the greatest risk, namely undue concentration of investments in one place or with any one enterprise, ownership of subsidiaries, and matching of assets and liabilities."[10]

The Task Force has concluded, after reviewing all of the relevant material, that tests which are dependent on the payment of dividends by a company or on the availability of earnings for dividends in the past, provide in many cases little or no assurance as to the ability of that company to service further investment, or as to the security of such an investment. Indeed, we are concerned that such tests may be taken to provide some assurance as to the desirability of an investment which is quite

misleading. It is far too easy to qualify the preferred and common shares of a corporation as permissible investments by maintaining a dividend on a limited capitalization. Accordingly, the Task Force has concluded that all of the tests contained in the proposed legislation which are dependent upon the dividend and earnings record of a corporation should be eliminated and that the overriding test for any investment should be one based on prudent investment standards established and applied with that degree of care, diligence and skill that a reasonable and prudent person would exercise in comparable circumstances. Accordingly, *we recommend that:*

10. Prudent Investment Standard

The statutes governing the regulation of financial institutions in Ontario should be amended to replace the current investment rules requiring compliance with qualitative tests by a prudent investment standard.

In our view, the most appropriate vehicle for ensuring that a prudent investment standard is enforced is to require that there be an investment committee of the board of directors, charged with the responsibility to establish prudent investment standards to be applied by the corporation in making investment decisions and in managing its total investments, including its deposits. The standards established by the investment committee should be required to be approved by the board of directors as a whole, either with or without modification.

The draft consultation Act, 1985, on loan and trust companies, provides for the establishment of investment committees and the establishment of procedures to ensure that prudent investment standards are followed by the corporation. We are in agreement with these proposals, subject to our earlier comments on removal of the qualitative tests, and believe that the same principles should be extended to insurance companies and to credit unions. Accordingly, *we recommend that:*

11. Investment Committees

Each loan or trust company, insurance company and credit union should be required by statute to appoint an investment committee of the board of directors. The investment committee should be required to establish prudent investment standards to be approved with or without modification by the board of directors and to be applied by the corporation in making investment decisions and in managing the investments of the corporation including deposits.

Finally, some of the submissions made to the Task Force strongly urge that the only test required by the legislation should be a prudent investment test. The Task Force endorses the thrust of the draft loan and trust legislation in applying some very specific rules as to the size of investment that may be made in certain specified activities. As we noted in Chapter II, lack of diversification is one of the recurring variables in the insolvency of North American financial institutions and Canada's recent unfortunate experience with failures in financial institutions indicates all too clearly the need for diversification in the investment portfolios of such institutions. It has also demonstrated that far too frequently the managements of financial institutions have not established prudent investment policies, but rather have been prepared to assume inordinate risks. These imprudent policies have resulted in failure after failure and prove, if proof were needed, that the solvency of financial institutions is unlikely to be maintained by an abdication on the part of legislators and regulators of any responsibility for the types of investments to be made by financial institutions in favour of a reliance on the prudence of the management of each and every one of these institutions. Thus, subject to the

elimination of tests dependent on the past earnings and dividend payment records of companies, the Task Force endorses the requirements of the draft legislation.

We believe that diversification of investments is crucial to the solvency of financial institutions and that it should be one of the prime considerations in the investment strategy of financial institutions. We take note also of Professor Seymour Friedland's submission that regionally-based financial institutions should be required to diversify their assets both sectorally and regionally.[11] In order to ensure healthy diversification, a duty should be imposed on the investment committee to establish prudent investment standards that require the corporation to diversify its investments, through quantitative limits, by type of security, by the amount of any single investment, by industry group, by region and by unrelated groups of persons. Accordingly, *we recommend that:*

12. Diversification

Diversification should be one of the principal objectives of the investment strategies undertaken by regulated financial institutions. Accordingly, the investment committee should be required, in establishing prudent investment standards, to adopt policies designed to avoid an undue concentration of risks. This can only be done by the establishment of rules that place limits on investments:

(i) in any one corporation;

(ii) in any one industry group;

(iii) in any one region;

(iv) in companies that are associated;

(v) in any particular type of security.

The investment committee should be required to review such investment policies and their implementation on a regular basis and also should be required to review periodically the investment results.

Chapter VI

Serving the Consumer

Networking

The Task Force has considered the submissions made by a number of financial institutions that their powers should be extended radically to permit them to undertake, in one way or another, virtually any activity which any one of the 'four pillars' currently can undertake. As indicated elsewhere, the Task Force has concluded that it is not desirable at this time to make such a radical change in the financial system. Rather, we believe that the desirability of providing a one-stop service can be tested by a system of networking among financial institutions so that the services and products normally provided by one institution can be offered, through regulated co-operation, by another institution not directly authorized to do so.

One of the reasons for the creation of this Task Force was the initiatives being taken in the financial community to create one-stop financial service shopping centres. Our survey research indicates considerable public skepticism towards this innovation and reveals that public opinion does not accept the one-stop shopping argument as a rationale for regulatory change. When asked whether changes to the regulation of financial institutions should extend to allowing one-stop shopping, the majority of Ontarians (61 percent) supported the statement that "one-stop shopping for all financial services does not appeal to them as they like the way things are now with each type of financial institution having its own unique services." However, the public opinion survey indicated that 58 percent of respondents share the view that change will lead to greater competition in the financial services industry and also will enhance its stability. A (bare) majority is willing to consider the provision of "a few more services" by any of the existing pillars.[1]

From the perspective of financial institutions themselves, there is evidence that one-stop shopping may not be as successful as had been hoped. A recent article in *Fortune*, for example, addresses the problems being faced by Sears Financial Centers in the United States. According to that source, the financial supermarkets in the Sears stores remain unprofitable due to the limited public appeal of one-stop financial shopping and the fact that the 'synergies' that were to spring from the combination of Sears affiliates "have been slow to materialize."[2]

Having rejected the fundamental change that would permit any institution to provide any financial service, we consider that market forces can resolve the issue of whether one-stop shopping is attractive if networking is permitted among different institutions.

It should be recognized that any system of networking is likely to increase the conflicts which today exist in the financial services industry. All of the participants now attempt to build a relationship of trust and confidence with their customers in providing a wide variety of services and many have been very successful in doing so. Such a relationship demands that those inducing it justify the confidence placed in them. At present the participants from time to time have problems when the interests of their customers vary from their own or when they are serving conflicting interests. The circumstances in which fiduciary duties are likely to be imposed are not a closed category, but rather are expanding as the nature of business changes, presenting different situations in which courts

will conclude that the duty of loyalty, care and confidentiality attendant upon a particular business relationship has created a fiduciary relationship.[3]

Although our courts do provide remedies for breaches of fiduciary duties, the Task Force believes that it is important that the problems presented by conflicts of interest be recognized in any networking arrangement so that the interests of customers may be protected. The Task Force also believes that networking arrangements should be such that the business of the participants does not become so intertwined as to make it difficult to supervise and regulate the individual businesses being conducted. No networking arrangement that amounts to tied selling should be permitted. A properly ordered system of networking should also recognize that the provision of different financial services requires personnel with different kinds of expertise. Thus, we have concluded that networking arrangements among financial institutions should be approved by the regulators responsible for the regulation of the corporations involved so that they may determine the desirability of such arrangements and the terms upon which they should be undertaken. Finally, in determining the desirability of networking arrangements, regulators should be sensitive to the particular needs of consumers who live in communities served by only one financial institution. For example, it appears that more than 500,000 Ontarians live in communities serviced only by a bank.[4] Accordingly, *we recommend that:*

1. Regulatory Approval of Networking Arrangements

When two or more financial institutions propose to enter into a contractual arrangement in regard to the sale of financial products or services, such an arrangement should require the approval of whichever regulators may be responsible for the supervision of the respective contracting parties. Before approving any arrangement, the regulators should be satisfied that the proposed arrangement will not result in practices that are directly or indirectly akin to tied selling, that the contracting parties possess the necessary expertise to offer the services that are the subject of the arrangement and that they have procedures in place to guard their customer against any adverse consequences as a result of any conflicts of interest arising from the arrangement. In assessing the desirability of particular networking arrangements, the regulators should take favourable note of arrangements designed to enhance consumer services in small communities.

Having regard to the need to preserve the confidence of customers in the financial system, it is very important that in any networking arrangements the participants disclose to the customer any interest which may affect the advice they are tendering, such as the desirability of engaging the companies associated with the participant providing the networking service. In our opinion, where a financial institution is engaged in providing a service originated by another institution pursuant to a networking arrangement, such financial institution should be required to disclose its interests, if any, in the institution providing the service and whether it is obtaining some pecuniary or other advantage as a result of the transaction. Accordingly, *we recommend that:*

2. Disclosure of Networking Arrangements

All parties to a networking arrangement should be required to disclose to their customers the existence of the arrangement and any advantage that accrues to them from a referral or sale pursuant to the arrangement.

While the disclosure to customers of the existence and advantages of a networking arrangement will do much to preserve the confidence of the public in the financial system by ensuring that consumers are well-informed of the synergies existing among the suppliers of financial products and

services, consumer confidence and knowledge can be further enhanced by an awareness of the range of choices existing in any particular product market.

When a financial institution wishes to refer a customer to the services offered by another institution with whom it has entered into a networking arrangement, public policy should dictate not only that the existence of the arrangement be disclosed but that the customer be advised of the availability of alternative sources for similar products and services. Particularly in the insurance sector, the public should be informed that independent brokers and agents who, as our public opinion research indicates, offer a valuable and impartial service to consumers of insurance products, exist as an alternative source of advice and supply. Indeed, independent brokers have a vital role in fostering competition in the markets for many financial services. We consider it in the best interests of the public and their confidence in our financial system that consumers be fully apprised of their options in purchasing financial products and services. Accordingly, *we recommend that:*

3. Disclosure of Available Options

All parties to a networking arrangement should be required to disclose to their customers the availability of alternative sources for similar products and services, including independent agents and brokers, and that their customers are free to obtain their requirements from such sources.

Independent Agents and Brokers

In Ontario, distribution of insurance products is carried out both through independent agents and brokers and through the representatives of particular insurance companies. A small group of insurance companies sell exclusively through their own captive agents but the majority of insurers market their products through independent business agents or brokers.

The general insurance brokers have been self-regulated under the *Registered Insurance Brokers of Ontario Act* since 1981. Their association, the Insurance Brokers Association of Ontario (IBAO), made oral and written submissions[5] to the Task Force in respect of the role played by independent brokers in the distribution of general insurance in Ontario and in the provision of independent advice to consumers. Given that an estimated 84 percent of general insurance in Ontario is handled by brokers, and that nearly all Ontario residents purchase home, automobile or commercial insurance, clearly insurance brokers perform a crucial function with respect to the financial security of most individuals and businesses in this province.

Independent agents and brokers also serve another important objective in the distribution of financial products. We refer to the independent nature of their advice and the specialized expertise which they have developed in selling a wide variety of insurance products to Ontario consumers.

Because brokers are not employed by or committed to any single insurance company and because they are required by law to engage only in the business of selling insurance, they are in a unique position to offer objective and knowledgeable advice about a wide variety of insurers and their policies. Moreover, the RIBO Act specifies that its members not be involved with any business that would put them in a position unduly to influence the consumer to do business with them. Since vertical and tied selling practices are prohibited under the Act, the services provided by brokers are singularly independent in an age when conglomerates represent a significant presence in the financial industry.

The value attributed to their services is confirmed by the results of our public opinion research. When asked for their general impressions of independent agents and brokers, 79 percent of those questioned responded that their attitude was very or somewhat favourable. Ontarians tend to believe that brokers provide very personal service, offer very expert advice and, to a lesser extent, believe they offer the best rates. Another survey, which was carried out for the Canadian Federation of Insurance Agents and Brokers Associations in August 1985, found that general insurance agents and

brokers generate more public confidence than a number of other professional groups providing financial services.[6]

In their submission to the Task Force, the IBAO expressed concern that consumers be protected from conflicts of interest at the point of sale. They suggested that conglomeration in the financial industry could result in consumers being subjected to coercion at the point of sale, tied-selling, a lower standard of service and advice and, consequently, an inferior insurance product. The Association was opposed to the concept of one-stop shopping and networking and argued that, particularly in the general insurance field, it would be difficult to regulate such arrangements so as to prevent coercion at point of sale and unfair competition.[7] We take cognizance of the IBAO's concerns and acknowledge that networking arrangements could have adverse effects on their competitive position. It is precisely to counter such effects that we have formulated the disclosure requirements recommended earlier in this chapter. Nevertheless, other measures may be necessary to ensure that the role of independent agents and brokers is supported. The need for such measures should be monitored in an ongoing manner. In particular, the Government of Ontario should take special care that its own regulatory and policy initiatives taken with regard to financial institutions will preserve a climate that is favourable to the role played by independent agents and brokers in enhancing competition and quality of service. Accordingly, *we recommend that:*

4. Independent Agents and Brokers: Maintenance of Role

Given the recognized and important role played by independent agents and brokers in the provision of personal service and objective advice to consumers, the Government of Ontario and the regulatory authorities, in approving legislative initiatives and in particular networking arrangements, should take special care to preserve a climate in which the role played by independent agents and brokers will be supported and maintained.

We have been favourably impressed with the initiatives taken by independent agents and brokers to develop educational and training programs through the Canadian Federation of Insurance Agents and Brokers Associations and the Life Underwriters Association of Canada. They have established licensing courses and examinations and continue to develop ongoing professional education programs to improve the standards of qualifications and ethics in the insurance brokerage community. They also maintain a close working relationship with governments in their ongoing efforts to make self-regulation more effective and efficient.

The support of government in the continuing educational initiatives of the independent agents and brokers will have benefits to consumers, to the agents and brokers and to regulators. A good insurance broker can be invaluable, especially to the unsophisticated client, in such matters as assessing the solvency of insurance institutions. This is a form of expertise that the brokers are currently attempting to develop and the Government of Ontario should encourage them in these and related initiatives. Brokers themselves will benefit from the contributions of government in building and strengthening their capacity to compete in a framework that permits networking arrangements among financial institutions. For their part, regulators can utilize the experience and knowledge of brokers in devising effective regulatory mechanisms, such as early warning systems, in the insurance industry. Accordingly, *we recommend that:*

5. Support of Educational Initiatives

The Government of Ontario should take steps that will assist the associations of independent life and general agents and brokers to offer educational and licensing programs which meet the challenges created by the emergence of new products and services, and which improve the capacity

of their members to assess the soundness of the institutions concerning whose products they advise the consumer.

During the consultation process of this Task Force, the distinctions between independent brokers and captive agents in the insurance sector and their respective roles in the Canadian financial system were highlighted. The wide variety of insurance policies and products and, in particular, the consequences that the terms of different policies may have as to the compensation for an insurable loss have also been brought to our attention. Since the so-called captive agents can offer the products only of one particular insurance company while brokers are free, indeed have a mandate, to ensure that customers obtain the best policy for their needs, we consider that the interests of the public would be better served by making these distinctions clear.

It is our view that both brokers and agents have valid functions and offer distinct benefits but we are concerned that their differences and the implications of those differences are not widely known to their clientele. Accordingly, *we recommend that:*

6. Disclosure Requirements for Insurance Agents and Brokers

All insurance agents and brokers should be required to disclose to their customers the extent of their capacity to sell various types of insurance products and the products of a variety of insurers.

Social Assistance Recipients and Financial Services

The submission of Parkdale Community Legal Services, Inc.[8] to the Task Force has brought to our attention a matter that we consider deserving of concerted action by government and banks. The problem relates to the inordinate difficulties experienced by a variety of individuals on social assistance with respect to cashing their benefit cheques. These persons are often unlikely to be regular bank customers or to have the types of identification regularly required for bank services and so may be denied access to the cheque-cashing services that they urgently need.

The seriousness with which we view this problem prompted us to consult representatives of both the banking community and social services agencies. We appreciate that the problem is recognized but consider that its scope requires enhanced co-operative efforts on the part of banks and government. There exists a range of possible solutions, including the use of direct-deposit schemes by social service agencies and the development of photo-identification cards. The direct-deposit plan has been the subject of experimentation by agencies in some regions and could be implemented in other areas to alleviate a significant degree of the problem.

It remains that even with implementation of a direct-deposit plan, some social assistance recipients, particularly those who have been unable to establish a fixed place of residence, will still experience difficulty in arranging for their benefit cheques to be cashed. The Task Force is not able to measure either the magnitude of this problem or the extent of loss that more lax identification procedures might cause and so, without more actual experience and experimentation, cannot recommend a complete solution to the problem. We do urge the government, however, to take every possible step both to determine the actual costs and risks in this area and to encourage the efforts of social service agencies and financial institutions to find a workable solution. Accordingly, *we recommend that:*

7. Social Assistance Recipients: Cheque-Cashing

The Government of Ontario should undertake to develop and implement measures to assist social assistance recipients in the cashing of their cheques, including ways

(i) to expand the use of direct-deposit schemes by social service agencies issuing cheques to members of the public; and

(ii) to encourage financial institutions and social service agencies to consult, on an ongoing basis, concerning any other appropriate steps, including the development of photo-identification cards, that will facilitate cheque-cashing by welfare recipients.

On a related issue, we are perturbed by the practices of cheque-cashing businesses and businesses providing advances on income tax refunds. Such enterprises have found their market niche by providing services akin to the cheque-cashing or short-term loans offered by established and regulated institutions. Public demand for the services of these enterprises may be rooted to some considerable degree in inefficiencies that are remediable, whether within financial institutions, social service agencies or Revenue Canada. Whatever the source of the demand for their services, it is also a matter of concern that the enterprises involved are essentially unregulated with respect to the fees they charge, and that their clientele is composed in substantial measure of individuals with relatively low levels of income and education. The Task Force received evidence that some of these enterprises, in addition to charging excessive rates, also adopted reprehensible practices in their business dealings. We consider that the situation we have described warrants the concentrated attention of government. Accordingly, *we recommend that:*

8. Cheque-Cashing and Income Tax Refund Enterprises

Federal and provincial officials, by directive of the ministers responsible, should undertake to explore means whereby public demand for the services of cheque-cashing businesses and enterprises providing advances on income tax refunds would be reduced, and to examine regulatory measures designed to curtail the charges that are levied for these services.

Conflicts of Interest and Confidentiality of Information

The Task Force is very concerned about conflict of interest issues for all types of financial institutions. As distinct from the problems of self-dealing, our discussion of conflict of interest here centres on the relationship which arises when an institution's own interests differ from the interests of its clients, or when it attempts to serve the interests of clients with conflicting objectives. Financial institutions have attempted sometimes to resolve these problems by erecting what have come to be known as 'Chinese Walls' and in other cases by disclosing the conflicts to the clients involved and resolving them by common consent.

Some of the submissions made to the Task Force recognized these problems, but took the position that they were not of great concern as the institutions involved had successfully resolved them over a long period of time while providing good service to their clients. While recognizing that financial institutions have made these efforts and that in the main they appear to have succeeded, the Task Force is concerned that the problems as to conflicts of interest are likely to increase as more financial institutions engage in networking and expand their powers so as to do business in many different sectors of the financial industry. The opportunities for conflicts in such situations are many and varied, but a few examples will suffice. A financial institution engaged in managing funds may have some difficulty in recommending the sale of shares of an associated company. Similarly, a financial institution engaged in commercial lending may have some inhibitions about making a similar recommendation as to the shares of a company to which it has made a commercial loan when it has confidential information from the borrower reflecting unsatisfactory business prospects. A financial

institution engaged in managing the portfolio of a customer has an obvious conflict when it recommends the purchase of shares which it is underwriting. A financial institution, such as a life insurance company which does financial planning, is often placed in a position of trust and confidence by the client and, as such, given confidential information. Such information may be very valuable to companies associated with it in a networking arrangement or by common ownership and, accordingly, there may be some temptation to use the information in selling their particular products.

These situations involve many cases where there is a fiduciary duty owed to the client. The common law has long recognized that special obligations arise whenever a relationship is created in which a person justifiably places trust and confidence in another and consequently entrusts that other to undertake some task or disclose confidential information. It is clear that the law as to fiduciary obligations is not a closed book, but rather that the courts are prepared to evolve concepts to meet new and differing commercial relationships. The Task Force believes that it would be undesirable to attempt to codify for financial institutions any set of rules which would, or could, be construed as a substitute for the common law on this subject. We do consider, however, that the public interest in maintaining the integrity of the financial system justifies the establishment of a system by which allegations of conflicts of interest could be investigated, as we have recommended in Chapter III of this Report.

The common law of trusts and the legal duties owed in the fiduciary relationship are, in our opinion, sufficient to deal with most types of conflict of interest. Where a clear fiduciary relationship exists, the common law imposes an obligation on the trustee not to use information obtained in the fiduciary context for the benefit of the trustee. We do not consider it necessary to legislate this well-established principle of common law in the context of financial institutions regulation. Nor do we consider it necessary to legislate requirements for Chinese Walls as we view the internal mechanisms necessary for compliance with the general duty of confidentiality to be developed best by individual institutions. However, the duty not to make use of or disclose confidential information should be extended to all conflict of interest situations, whether or not it is in the context of a trust situation.

Whether or not a fiduciary relationship exists, confidential information given by any person to a financial institution for a particular purpose, such as for a commercial loan or for the purpose of securing investment advice, should not be disclosed to any other institution or used for any other purpose within the same institution. The general principle should be that any information given in confidence to a financial institution should be used only for the purpose of the particular transaction for which it is provided. Accordingly, *we recommend that:*

9. Prohibition on Use of Confidential Information

There should be a statutory provision, applying to all financial institutions, that prohibits the disclosure of information obtained from any person dealing with the institution to any other person or the use of such information for any purpose within the institution other than the purpose for which such information was provided.

An exception to this prohibition should be provided for in the situation where the person giving the information consents in writing to the use of that information for some other particular purpose. However, the person's consent must be transaction-specific, that is obtained each time the information is to be used or disclosed. Accordingly, *we recommend that:*

10. Exception Where Consent Provided

An exception to the general prohibition should be allowed where the person supplying the information to the institution consents in writing to the use of that information in some other specific transaction.

The Task Force has some concern that financial institutions may develop contractual forms which will purport to relieve a financial institution of some of its fiduciary or other duties. There may, of course, be occasions when it is in the interests of clients to waive some of these duties, but, in our view, such a waiver should only take place where the effect of the waiver is clearly explained to the client. Accordingly, *we recommend that:*

11. Waiver of a Fiduciary or Other Obligation

There should be a statutory requirement that whenever a financial institution enters into a contract with a customer providing for any waiver of any fiduciary or other obligation of the institution to such customer, the waiver shall be ineffective unless the institution establishes that the customer consented to such a waiver after the full consequences of it were explained.

Chapter VII

The Ontario Loan and Trust Corporations Act

Consultation Draft 1985

In June 1985, the Ministry of Consumer and Commercial Relations released a consultation draft of a proposed Ontario *Loan and Trust Corporations Act*. This draft represents yet a further stage in the development of a comprehensive loan and trust policy which has been ongoing for some time and eventually will lead to passage of a new statute governing the operation of such businesses in Ontario.

During the almost continuous process of evaluating loan and trust policy over the past ten years, there has been a succession of studies, including a substantive review of loan and trust corporations law by a select committee of the Ontario Legislature, a number of special investigations and reports in the aftermath of the Crown, Greymac and Seaway Trust government takeovers, a 1983 ministry White Paper on proposed legislative changes followed by a report of the Standing Committee on Administration of Justice, and various working drafts, discussion papers and consultations with representatives of industry and other governments.

It is also worth noting that more than fifteen years ago, Mr. Justice Samuel H.S. Hughes chaired a Royal Commission inquiry into the collapse of Atlantic Acceptance Corporation and the related fall of the British Mortgage and Trust Company and other affiliates. That commission completed an exhaustive examination of the causes of those particular failures and made detailed recommendations for revisions to the *Loan and Trust Corporations Act*. Despite that substantive study in which the issues of self-dealing, conflict of interest, and liquidity of deposit-taking institutions were dealt with at length, the loan and trust industry has continued to suffer from problems in these areas, on an ever-increasing scale. The Atlantic Acceptance failure and the findings of the Royal Commission should have been adequate warning that a too easy reliance on existing structures of regulation was likely to produce the very results which we have now had. It is of great concern to this Task Force that failures of financial institutions have continued to escalate and we urge the Government of Ontario to enact legislation which will limit the risks of insolvency to the greatest extent possible.

The appointment of this Task Force coincided with the drafting stage of the new statute and while we have had the benefit of all of the studies and analyses previously done, we have also brought our own views and experience to this policy development endeavour and have had the additional benefit of numerous written and oral submissions related to this topic from interested parties and members of the public during our own consultation process.

One fundamental issue in developing new legislation is the degree of responsibility which the government and regulatory authorities should assume for trust and loan corporations. For all the reasons advanced in earlier chapters of this Report, the Task Force has concluded that the public interest requires that there be effective regulation of these institutions and that very high standards be established for their management.

Such institutions are a major part of our capital market system, being entrusted with a very large part of the savings of Canadians and employing those savings to finance a significant part of

the businesses and personal financial requirements of Canadians. The capital component of their total capitalization ranges from four to five percent — a much smaller capital component than would be considered reasonable for corporations engaged in other businesses. Although financial institutions can operate very successfully with a relatively low equity, as the strength of our financial system has demonstrated, there can be no doubt that the equity can be wiped out very quickly if imprudent lending and investment policies are adopted and public confidence is forfeited. A failure of any major participant can have serious consequences, not only for the shareholders and depositors of such institutions, but for other participants in the financial community, and, in the case of a very major failure, for the whole economy. The public expects governments to act to maintain an efficient and solvent financial system in which deposit-taking institutions will be able to repay their deposits in accordance with their undertakings. The Task Force has concluded that for all these reasons governments must and will be expected to assume substantial responsibilities for the efficient operation of the trust and loan industry and for the safety of its depositors. In these circumstances the Task Force believes that the legislation must establish a system for the governance and regulation of such institutions which will offer the best possible assurance that these public interest objectives may be met. In particular, it is our view that the opportunity to participate in this industry should be regarded as a privilege and not as a right.

It has been suggested that the requisite public policy objectives may be attained by greater reliance on self-regulation and by placing greater responsibility on the management and directors of such institutions. The Task Force has carefully examined these views in the light of the evidence available to it as to experience, both in this country and elsewhere. Our opinion is that it would be a grave mistake to believe that the recent problems encountered in our financial system could be solved in this way, although benefits can undoubtedly be obtained by imposing greater responsibility on directors and management and by encouraging a greater degree of self-regulation. The Canadian experience and the experience of other jurisdictions which have increased the responsibility of management and directors do not justify the conclusion that such measures are in any way a substitute for effective regulation.

We have examined the draft consultation act released by the Ministry of Consumer and Commercial Relations in June 1985 and believe that it is desirable legislation combining as it does requirements for more effective regulation, better controls on entry, and increased responsibilities for those involved with the management of the industry. We believe, furthermore, that this approach is supported generally by the industry and the public whose views were expressed to us during the course of our proceedings.

In dealing with specific provisions in the Draft Act, however, we discern a clear need for different provisions to meet more effectively the twin objectives of solvency and efficiency. In this regard, we draw particular attention to the recommendations made in the preceding chapters concerning changes that should be incorporated in the legislation governing all financial institutions. These recommendations embrace such matters as early warning systems, the role of audit committees and the duties of auditors, and should be specifically incorporated into the Ontario *Loan and Trust Corporations Act*. The recommendations made in this chapter address matters which are more specific to the loan and trust industry, although the general principles underlying them may be applicable to the revision of legislation bearing on other sectors.

Entry Requirements

The Draft Act imposes higher capitalization requirements for new entrants. A minimum of $5 million is proposed for a loan corporation, $10 million for a trust corporation and $15 million for commercial lending.[1] This represents a significant increase over the existing minimum levels of $1 million for both loan and trust companies. It should be noted also that the Draft Act proposes

a five-year transition for existing corporations to comply with the new capital requirements and further provides an exemption from prescribed capitalization for trust companies operating in a local or regional market.[2] In addition to other requirements, new charters and registrations will not be granted unless the regulatory authority is satisfied that each proposed director is fit, both as to character and competence, to be a director of a loan or trust corporation and the proposed plan of operations is feasible.[3]

These entry requirements were largely supported in the submissions to the Task Force. The Trust Companies Association of Canada, for example, stated that it was "very strongly of the opinion that it should be much more difficult to enter the business."[4] Increased capitalization is one means of both restricting entry and strengthening solvency and we, along with the industry association and others, endorse the proposed revisions in respect of entry requirements, such as higher minimum levels of capital. Higher capitalization is desirable not least because it encourages the development of sound business plans, another safeguard against insolvency. This, in turn, is related to the ability of directors and management to develop such plans. Their fitness, both as to character and competence, is fundamental to the future success of their corporations.

The Task Force believes that the enforcement of stricter entry requirements is absolutely essential if costly failures are to be minimized. Where in the past entry to a particular market has been permitted for newly formed, as distinct from already existing, institutions, the result all too frequently has been the formation of weak corporations prone to insolvency, rather than the enhancement of competition or service to the public. In our view the Lieutenant Governor in Council and the appropriate regulators should give special attention to the risk of insolvency when new financial institutions are being proposed and should consent to their formation only when it is clear that their creation is in the public interest. Healthy capitalization, the fitness as to character and competence of directors and management and a sound business plan should be essential prerequisites to the establishment of any new financial institution. We believe that competition and better service to the public are much more likely to be enhanced by permitting greater competition among existing institutions than by maintaining a relatively easy entry policy.

A number of submissions to the Task Force addressed the issue of the fitness as to character and competence of directors of financial institutions. They were overwhelmingly in favour of requiring higher standards, as a condition of entry, for those individuals who are responsible for the operation of loan and trust corporations. On the basis of these submissions and our own observations of historical events, we wish to stress the importance of the fitness of directors as a prerequisite to obtaining and maintaining a charter or licence to do business in Ontario. Such a charter or licence should be regarded as a privilege to be granted only after searching enquiries as to the character, competence and business plans of applicants. The renewal of a licence should only be made when the regulator is satisfied as to each of these vital issues.

The Task Force has found it easier to endorse the importance of ensuring the fitness as to character and competence of directors and management than to formulate methods of achieving this in practice. In some countries statutory tests have been devised and regulators are required by law to enforce specific provisions relating to the qualifications of directors and management of financial institutions. We have examined various tests for character and competence, such as the Bank of England tests drawn to our attention at the public hearings,[5] but do not find that they provide a sufficient guarantee of fitness because they ultimately depend on the judgment of the regulator about what is frequently a most vexing question. The Trust Companies Association of Canada has suggested that its members may be helpful in assisting the appropriate regulators in establishing benchmarks as to the manner in which a judgment should be made on the issues involved.[6] We think that advantage should be taken of this offer, but we do not think that it will be possible to develop precise tests as to fitness.

The reality is that unless there is a very clear case of lack of character or competence, the pressures on the Lieutenant Governor in Council and the regulator will be such that the licence will

be granted in most cases. In some cases it will be equally difficult to reject an application because the business plans appear to be inadequate. It is the view of the Task Force that when there is doubt as to any of these matters the public interest will be best served by a rejection.

Having regard to the recent unfortunate experiences in Canada and the magnitude of the costs of failures to all Canadians, we believe that the granting and renewal of the privilege of operating trust and loan corporations is an important part of the public administration of the province. We believe that the interest of the public will be advanced by a requirement that the regulator compile a compendium of information as to the matters about which the Lieutenant Governor in Council and the regulator are required to be satisfied as a condition of granting either a new charter or registration. The compendium would also contain information as to the qualifications of proposed directors. We believe that such a disclosure would be in the public interest, permitting the legislature to be assured that the privilege of operating such an institution in Ontario was only being conferred in appropriate circumstances.

With respect to any changes in directors, we accept the recommendations of various submittants, including the Institute of Chartered Accountants of Ontario,[7] that loan and trust corporations should be required to notify regulators of all such changes. Although the Draft Act does impose such a duty on corporations,[8] it should further specify an ongoing responsibility to ensure that newly elected directors meet the same standards of character and competence as incorporators. We agree with the submission of Trilon Financial Corporation which proposes "a requirement for prior regulatory approval of all directors of financial services sector companies, with approval to be withheld if any director does not meet specified standards of responsibility, reputation and substance."[9] Accordingly, *we recommend that:*

1. Ongoing Duty of Corporation

In addition to its statutory responsibility to advise the Superintendent of Deposit Institutions of every change in its board of directors, each corporation should have a continuing statutory responsibility to satisfy the Superintendent of the fitness as to character and competence of its directors.

2. Ongoing Duty of Regulator

The fitness as to character and competence of the directors of loan and trust corporations should be reviewed by the Superintendent upon the incorporation or registration of a corporation, and upon notification of a change in the board of directors of a corporation.

3. Deposit with Standing Committee

The upgraded entry requirements proposed in the draft consultation act for loan and trust corporations carrying on business in Ontario, such as increased capitalization and more stringent character and competence qualifications, should be further formalized by the addition of a statutory provision that the Superintendent deposit a file with a standing committee of the legislature relating to each newly incorporated or registered corporation and each corporation that has reported a change in its board of directors. The file should take the form of a compendium disclosing the relevant information on the fitness as to character and competence of the board of directors of such corporations and, in the case of each newly incorporated or registered corporation, relevant information as to the matters required to be established to the satisfaction of the Lieutenant Governor in Council or the regulator in respect of such incorporation or registration.

Directors' Duties

The Draft Act imposes a greater degree of responsibility on the directors of loan and trust companies than has previously been required. As part of the new regulatory scheme emphasizing greater corporate accountability, a new requirement for outside directors has been proposed and a new standard and duty of care have been introduced. These provisions require directors to exercise "the care, diligence and skill of a reasonably prudent director in comparable circumstances" and to have due regard to the interests of depositors as well as the shareholders of the corporation when considering whether a particular decision is in the best interests of the corporation as a whole.[10]

The Task Force endorses the increased responsibility of directors as proposed in the Draft Act, particularly the new standard of care and the duty to consider depositors' interests. In Chapter V we recommend additional duties that directors should be required to undertake, notably through the use of audit and investment committees. As we have previously indicated, we believe that the confidence that is essential to market efficiency depends on the extent to which financial institutions are well run and accountable and, in this regard, we want to stress, among other things, the crucial role and responsibilities of the board of directors. We do not consider, however, that it is advisable to require a depositors' director and we received no support for such a proposal during our consultation process. As important as the role of directors is in ensuring a responsibly run institution, we do not regard increased liability of directors as a substitute for strict statutory controls on self-dealing or specific requirements as to prudent management practices and we propose additional duties for directors in respect of particular matters discussed elsewhere in this Report.

In our Interim Report, we recommended that the *Loan and Trust Corporations Act* should have a requirement that directors having a conflict of interest on any matter not be present when such a matter is being discussed or voted upon by the directors.[11] The Canadian Bankers' Association endorsed this recommendation in its submission to the Task Force[12] and we are pleased to see that it has been reflected in the Draft Act.[13]

It is essential that the board of directors of financial institutions exercise their powers in the interests of such institutions and their depositors. A number of submissions to the Task Force stressed that this objective was more likely to be attained if such corporations had as members on their board persons who were not associated with those in control of such institutions. We endorse their views.

The issue of interlocking directorships is also addressed in the consultation draft. It is proposed to limit an individual to the directorship of only one registered loan or trust corporation (other than an affiliate), a proposal similar to the restrictions imposed by the *Bank Act*. The Consumers' Association of Canada, among others, has lobbied for measures to limit interlocking directorships much more stringently than this. The Task Force agrees that there should be such limits, but we do not believe it desirable to prevent directors of other businesses from being directors of trust companies, as it is important for trust companies to have directors experienced in business matters. We also do not think it would be desirable to have legislation which would prevent a trust company from doing business with a corporation with which it shared a director. Such a rule would place real impediments on the recruitment of experienced directors who would, in our judgment, be loath to serve as directors if it meant that their corporations could not, in any circumstances, do business with the financial institution of which they were a director. Instead, we believe that the proper approach is to ensure that directors are not acting as directors of competing institutions and to ensure that any conflicts that a director may have are declared and that where such a conflict exists, that director be prohibited from participating in the decision.

Finally, we have concluded that each trust or loan corporation should have a management resources committee of the board which would review management systems, evaluate the performance of management, plan for its succession, establish compensation programs and ensure con-

tinuity of good management at all times. This is a function that could be performed by the board as a whole and for which it must take the ultimate responsibility. Nevertheless, it is the view of the Task Force that this function is more likely to be performed well if a small committee responsible to the board is charged with it, particularly when many corporations have members of management serving as board members. Accordingly, *we recommend that:*

4. Directors Generally

The provisions of the draft consultation act pertaining to outside directors, limits on cross-directorships and the standard of care required of directors should be enacted substantially as drafted, augmented by the additional responsibilities of directors as prescribed in the foregoing recommendations of this Report.

5. Management Resources Committee

The directors of a loan or trust corporation should have an additional statutory duty to appoint a management resources committee composed of outside directors with the responsibility to review management systems, to develop compensation programs, to evaluate the performance of management, to plan for the succession of management and to ensure continuity in the good management of the corporation at all times.

Disclosure

Public confidence in the solvency of the financial system should be regarded as a paramount objective. To this end, provisions requiring increased disclosure by financial institutions to the public should be implemented.

The consultation draft provides for some degree of disclosure of information about financial institutions through publications of the Trust Companies Association of Canada and through the public file required to be maintained by the Superintendent.[14] We support these initiatives but wish to extend them further. Steps should be taken to make information more accessible to members of the public who may be unlikely to deal with the office of the regulatory authority and who may be unaware of the availability of such information. As the Consumers' Association of Canada pointed out in its submission to the Task Force, many consumers are eager to manage their affairs wisely and would benefit from additional disclosure of financial information.[15] The Institute of Chartered Accountants of Ontario also supports this view, stating that information should be available to investors "so that they can see a bill of health of the basic financial position and results from time to time."[16] Such disclosure should be in uniform format and should be required of all financial institutions. It is of the utmost importance that the government take steps to encourage consumers to address the soundness of the institutions with which they deal.

Mr. S. Sarpkaya recommended to the Task Force that each Ontario institution should make its quarterly and annual reports public within two months after the reporting date.[17] In our view, disclosure will be most effective if depositors have the right not only to obtain a copy of the latest financial statement but also to obtain the most recent interim financial statement. If this right is to be exercised, depositors must be informed of it. Accordingly, *we recommend that:*

6. Disclosure of Financial Statements of Corporation

A statutory duty should be imposed on all registered loan and trust corporations to provide any depositor upon request with a copy of the corporation's most recent annual and most recent

interim financial statement and to notify all depositors of the corporation, in writing, at least once annually of their right to obtain such statements.

In addition, the level of quality of disclosure required in both interim and annual financial statements of loan and trust corporations would be significantly improved by the disclosure of all related party transactions that have been permitted under Part IX, the conflict of interest section, of the Draft Act. Precedent for a similar type of disclosure already exists in the securities legislation and was endorsed in principle by the Institute of Chartered Accountants of Ontario during our public hearings.[18] In practice, the extent of the disclosure that we advocate should involve sufficient detail to permit an informed reader to formulate a business judgment as to whether the transaction was desirable. Accordingly, *we recommend that:*

7. Disclosure of Related Party Transactions

Loan and trust corporations should be required to disclose in their financial statements the occurrence of all related party transactions permitted under Part IX of the Draft Act during the period covered by the statement, together with such information as may be required to permit a person to have an informed judgment about them.

Self-Dealing

Our Interim Report assigned urgent priority to regulatory prohibitions against self-dealing, that is transactions carried out between the owners, or those in control, of financial institutions and the financial institutions.

Following our interim recommendations, the Draft Act was prepared incorporating the fundamental principles which we advocated. We support the self-dealing prohibitions as they appear in the consultation draft and we consider them to be both effective and feasible and recommend their adoption at the earliest possible time.

We are gratified that the submissions to this Task Force were overwhelmingly in favour of strict controls over self-dealing and a number of submittants, including the Canadian Bankers' Association and Mr. J. Douglas Gibson, a very experienced director, endorsed our recommendations in this regard.[19] If it were practical we would prohibit self-dealing in every form whatsoever, but in practice this would restrict unduly investment and would introduce difficulties in managing the reasonable affairs of the corporation. We take this opportunity to reiterate most strongly that self-dealing in financial institutions should be virtually banned and that exceptions to the general prohibition should only be permitted where the test of market value can be met. Experience has proved time and time again that self-dealing is very often a root cause of insolvency. Given the increasing number of failures of financial institutions and a clear link between insolvency and self-dealing, it is of the utmost importance that governments act urgently to terminate these dangerous practices. Our recent experiences in Canada with incidents of self-dealing affecting the solvency of financial institutions have been alarming but may well be less severe than those of other jurisdictions. A recent U.S. report, for example, attributed 45 percent of bank failures in 1982 to malfeasance.[20] Accordingly, the risk involved in self-dealing is too great to be acceptable.

Some participants in our public hearings argued that as, by and large, trust companies are run by honest and conscientious individuals, our recommendations as to self-dealing were too severe. Clearly, most trust companies have been run by honest and conscientious individuals but, unfortunately, there have been exceptions and these exceptions have led to costly failures. It is quite clear that there have been too many participants who have acted in bad faith and that, accordingly, the regulatory system must be designed to ensure that such persons are unable to appropriate the assets of such institutions for their own benefit.

Some institutions have instituted business conduct review committees to review all transactions involving related parties. We commend these efforts and support the view that imposing greater responsibility on independent directors to police self-dealing transactions is desirable. However, we do not believe that such measures provide adequate safeguards against self-dealing. As one witness put it, 'pliant directors' can always be found who will be more vigilant in ensuring the best interests of the controlling individuals than ensuring the interests of the corporation and its depositors.

Some witnesses, while recognizing these dangers, took the position that self-dealing transactions may be beneficial to financial institutions and that, accordingly, it was unwise to impose a virtual ban on them. After carefully reviewing the experience both in Canada and abroad with self-dealing transactions in respect of which a market value is not available, we have concluded that the costs will far outweigh any conceivable benefit from such transactions.

There are self-dealing transactions which are clearly fraudulent and which may be readily identified as such by an astute director or regulator. There are other cases where the fraud is not so easily detected and, accordingly, the safer course is to prohibit them when a market test is not available. In addition, it must be recognized that there are dangers to any financial institution in all types of self-dealing, whether or not fraud is involved. Many transactions occur in our society in which people of good faith can reach very different conclusions as to the value of a transaction. It is the judgment of the Task Force that true value is only reached by a process of arm's length bargaining and that there cannot be any adequate substitute for this ultimate test of real value. It is not reasonable to expect regulators, or even directors, to have the ability or resources to evaluate many complex transactions. The primary responsibility for making such decisions must rest on an informed management intent solely on the pursuit of the interests of the corporation and devoid of the pressures and conflicts that are present when a corporation is dealing with its owners or controllers.

In our Interim Report we concluded that transactions between related parties should only be permitted when the transaction involves services or commodities for which a market value is readily and clearly ascertainable. After reviewing all of the submissions made to the Task Force, conducting our own research and hearing the views expressed during the public hearings, we have had our initial views on self-dealing reinforced and have heard nothing that would persuade us to change our views on the desirability of a virtual ban on self-dealing. In particular, we are in substantial agreement with the category of restricted parties, as drafted in the proposed *Loan and Trust Corporations Act*, and we emphasize that the objective of this provision should be to make any person who has any significant degree of interest in the corporation a restricted party. We also endorse the position taken in the legislation on prohibited activities and emphasize that the category of permitted exceptions to the self-dealing provisions should not be further extended in any way.

Section 144 of the Draft Act gives the Superintendent the discretion to allow otherwise prohibited self-dealing transactions where they are deemed to be necessary to the well-being of the corporation. For the reasons indicated earlier, regulators will have grave difficulty in evaluating such transactions. Indeed, there is much to be said for imposing a complete ban on such transactions, save for the cases specifically permitted by the draft legislation where a true market value comparison may be made. There may, however, be rare cases where a corporation can establish that a particular transaction is necessary to its well-being. In such instances, the onus clearly should be on the institution to prove that such a transaction is indeed beneficial and each case should be regarded with considerable skepticism, given the difficulty that any regulator will have in evaluating non-arm's length transactions. We believe that the regulator should have the power to employ agents to evaluate such transactions in cases where the regulator does not have sufficient experience to do so. We stress that there can be a wide range of seemingly justifiable opinions as to market value in many transactions and that, accordingly, it is difficult to conclude that the views of experts may ever be a substitute for the conclusions reached in an arm's length transaction.

Having regard to all of these difficulties and the need to minimize the number of approvals, we urge that Section 144 be changed to require an approval by the Lieutenant Governor in Council

of any transactions which have been supported by a recommendation of the Superintendent. We advocate as well additional steps which would further formalize the allowing of otherwise prohibited transactions by requiring a compendium of information about any such consents to be deposited with a standing committee of the legislature on a regular basis.

Complementing our recommendations in respect of the increased responsibilities on auditors, we endorse the provisions of sections 149 and 150 of the consultation draft that impose a duty on auditors and persons rendering professional services to the corporation to report to the directors any breach of the self-dealing prohibitions of which they become aware. However, these provisions would be far more effective if they required such reports to be made simultaneously to the regulatory authorities.

With respect to the legal profession, we are concerned about the effect of the proposed s.150(3) respecting solicitor-client privilege and believe that, as currently drafted, it may eliminate many self-dealing transactions from coming to the attention of regulators. In view of the evidence that lawyers have often had knowledge of self-dealing transactions in troubled financial institutions in the past, we believe that there should be greater responsibility on lawyers and other professionals in this area. However, we also appreciate the importance of the principle of solicitor-client privilege in our legal system. We suggest that a review be undertaken by the appropriate body on the question of how absolute the solicitor-client privilege should be, especially in relation to knowledge of self-dealing transactions in financial institutions. Accordingly, *we recommend that:*

8. The Extent of the Prohibition

The approach taken in the Draft Act to banning self-dealing should be adopted and, having regard to the inherent dangers of self-dealing, the exemptions to the ban should not be further extended in any way. We reiterate the recommendation in our Interim Report that the overriding policy consideration in drafting the self-dealing provisions of the Act should be to prohibit all non-arm's length transactions in every case unless true market value can be objectively ascertained by independent means and we emphasize that, in regulating self-dealing, greater responsibility on directors and greater regulatory discretion cannot substitute for the impartiality that results from arm's length negotiations.

9. Consent to Prohibited Transactions

The exemption provided in section 144 of the Draft Act whereby the Superintendent may consent to an otherwise prohibited conflict of interest transaction should be amended to require that the consent be obtained from the Lieutenant Governor in Council, upon the recommendation of the Superintendent. Such approval should not be granted unless the applicant can establish that the transaction is in the best interests of the corporation.

10. Report to Standing Committee

It should be a statutory requirement that every exemption granted under section 144 shall be disclosed in a compendium to be filed by the Superintendent with a standing committee of the legislature.

11. Reporting of Conflict of Interest

The duty in section 149 and section 150 of the Draft Act that auditors and persons undertaking professional services for the corporation report to the directors any conflict of interest breach

of which they are aware should be revised to require that such reports be made simultaneously to the directors and to the Superintendent.

Conflict of Interest: Shares Held as Fiduciary

In more general terms, we are concerned about the protections that should be afforded to persons in a fiduciary relationship with a trust company where conflicts of interest arise that may prejudice such persons in their dealings with the institution. We consider it to be a deficiency in the Draft Act that these broad conflict of interest issues are not specifically addressed and we would like to emphasize that our recommendations relating to conflicts of interest, presented in Chapter V of this Report, have particular relevance to the position of trust companies.

One of the conflict of interest situations of particular concern to this Task Force relates to the conflicts that may arise when a trust company holds some of its own shares as fiduciary. Clearly, in such cases its interests may differ from its obligations to its client.

Generally, we do not believe that it is advisable to permit a trust company to acquire its own shares as fiduciary but we support, for pragmatic reasons, the approach taken in the draft *Loan and Trust Corporations Act* whereby a trust company may not invest in its own shares as fiduciary but may continue to act as a fiduciary for trusts owning shares of the company if such shares were acquired before the trust company assumed fiduciary responsibilities.

We also support the approach taken that shares of the trust corporation held as fiduciary should not be voted, sold or dealt with in any way by the corporation without the consent of the board of directors. However, we do not agree that this prohibition should come into effect only in cases where the trust owns more than ten percent of the shares of the corporation. Clearly there may be situations where far less than ten percent of the corporation's shares represent a significant element or where the aggregate of shares held by the corporation in a number of small individual trusts exceeds ten percent in total. For example, it is conceivable that such shares would be voted when there was some dispute as to control. In such a case the management of the corporation effectively might be voting on its own destiny. When a corporation has such a conflict of interest it obviously must consider very carefully its fiduciary responsibilities; in such circumstances we think it only appropriate that the ultimate decision as to those fiduciary responsibilities should be undertaken by the board. Similar considerations could apply to any sale of such shares where a takeover is in progress. In our view, the board of directors of the trust corporation should be required to review and consent to every vote or transaction involving any shares of the corporation held as fiduciary. Accordingly, *we recommend that:*

12. Trust Corporation Shares Held as Fiduciary

The provision in section 143 of the Draft Act prohibiting a trust corporation that holds its own shares as fiduciary from voting or otherwise dealing with such shares except with the consent of the board of directors, should not be conditional on a ten percent holding but should extend to any shares of the corporation held as a fiduciary.

Regulation

The 1984 report of the standing committee reviewing the 1983 White Paper on loan and trust corporations recommended that there be less emphasis in the statute on discretionary regulation and more on managerial and professional responsibility.[21] The Task Force agrees with the approach of greater responsibility on directors, auditors and other professional advisors, but takes the position that this cannot substitute for government regulation in many circumstances.

Unfortunately, directors can, and do, fail to discharge their existing responsibilities. Merely increasing the responsibilities is unlikely to achieve a better performance from directors who either carelessly or consciously concur in decisions detrimental to the corporation. The consequences to the public and to governments of the failure of such institutions are far too serious to permit a reliance on the greater responsibility of such persons as the principal line of defence against insolvency. As indicated elsewhere, the public interest requires effective and vigilant regulation of financial institutions so that the consequences of failures of directors and managers to act prudently may be minimized.

In general, then, the Task Force supports the revised regulatory structures proposed in the Draft Act, such as earlier intervention by regulators, an enforceable voluntary compliance program, the use of orders of the Director of Loan and Trust Corporations and the Superintendent's investigation power. We are also of the view that any cancellation or suspension of the licence of a loan or trust company should be required to be disclosed, together with the reasons therefor, in a compendium to be deposited with a standing committee of the legislature. Accordingly, *we recommend that:*

13. Regulatory Powers

The enhanced regulatory powers and structures in the Draft Act should be enacted substantially as drafted.

14. Suspension of Business

Whenever the right of a loan or trust corporation to carry on business is suspended by the Director of Loan and Trust Corporations, the Superintendent or the Lieutenant Governor in Council, the fact of the suspension and the reasons therefor should be disclosed in a compendium to be deposited with a standing committee of the legislature.

Commercial Lending

During the course of our deliberations, the Task Force has heard much about the importance to trust and loan corporations of the power to do commercial lending and the desirability of greater competition among financial institutions for this business. As we have discussed, competition takes place in distinct markets for different financial services. Where established institutions, which are less prone to solvency problems, enter new markets, the goals of competition and market efficiency are both enhanced. The expansion of activities of established loan and trust companies in the commercial lending field is justified on this principle. However, the Task Force emphasizes the need for trust and loan companies seeking to take advantage of expanded commercial lending powers to appreciate the particular nature of the risks associated with commercial lending, the nature of the staff expertise which is required to compete effectively in commercial lending while ensuring continued institutional soundness and the importance of appropriate standards to ensure appropriate portfolio diversification.

We also believe that the appropriate approach to any extension of powers at this time is by a gradual enhancement, as has been suggested in the draft legislation. Experience in this and other jurisdictions has demonstrated that commercial lending can often be a difficult business and that it is a business which can only be successfully pursued by persons whose experience makes them conversant with the risks involved. Accordingly, we believe that it is very important that the Superintendent, in exercising the right of approval of commercial lending powers, be satisfied that the applicant

corporation has a viable business plan for such an activity and has experienced personnel to implement it. If this is not done then there will be a real risk that the extension of commercial lending powers will imperil the solvency of some institutions. Accordingly, *we recommend that:*

15. Endorsement of Draft Provisions

The proposals in the Draft Act in respect of commercial lending which place three principal restrictions on the commercial lending of registered loan and trust corporations:

(i) approval of the Superintendent of Deposit Institutions;

(ii) minimum capital of $15,000,000;

(iii) restrictions to ten percent or less of total assets of the corporation

should be enacted.

Commercial Leasing

Together with commercial lending, commercial leasing is a business that demands a stable institution, able to assume the risks inherent in this category of financial products, and possessed of a high level of expertise. In our view, it is unlikely that the requisite standard of expertise could be acquired by a company with a relatively small capitalization.

For these reasons, similar restrictions to those required for loan and trust corporations wishing to engage in commercial lending should be required of those who wish to engage in commercial leasing. Accordingly, *we recommend that:*

16. Minimum Capital

In respect of commercial leasing, a further condition to those proposed in the Draft Act should be enacted. Minimum capital of $15,000,000 should be required as a prerequisite to commercial leasing.

Leverage Ratios

Financial institutions traditionally have a capitalization with a relatively high debt component and a low equity component. Such a capitalization obviously requires institutions to be managed prudently and efficiently as the small equity does not permit significant losses to be sustained without danger to the continued solvency of a particular institution. In recognition of this, the legislation governing trust and loan companies has traditionally placed limitations on the extent to which an institution could employ leverage. The draft legislation provides that deposits and borrowings of both trust companies and loan corporations shall not exceed an amount equal to ten times the capital base; *i.e.*, the shareholders' equity. However, the Draft Act would permit the Superintendent of Deposit Institutions, subject to any terms and conditions regarded as advisable, to increase the borrowing limit up to 25 times. Furthermore, the legislation would permit a financial institution to exceed its borrowing limit so long as the amount by which the limit is exceeded is invested in a manner prescribed by regulation.

It is very important that the regulatory authorities, in exercising this discretion, only do so when the experience of the management and the record of achievement of the corporation justify

it in using a high leverage ratio. The ability to use a leverage ratio beyond ten times should be regarded as a privilege which should only be granted when the record of the company clearly indicates that the public interest will not be prejudiced by doing so. Furthermore, whenever the regulatory authorities are not satisfied with the operations of a company the multiple should be reduced, recognizing that any doubt should be resolved in favour of preserving solvency. Accordingly, *we recommend that:*

17. Increases in Borrowing Multiples to be Approved

Any increases in the borrowing multiple of trust and loan corporations to any amount in excess of ten times the capital base should be approved by the responsible minister or by the Lieutenant Governor in Council. Each subsequent increase also should be so approved.

18. Deposit with Standing Committee

Information as to the increases in the borrowing multiples of trust and loan corporations granted in each year should be deposited with a standing committee of the legislature at least once per year in the form of a compendium prepared by the Superintendent of Deposit Institutions.

19. Reduction of Borrowing Multiple

The Superintendent of Deposit Institutions should be required to review the borrowing multiple of each trust and loan corporation at least once per year and where it is determined that the borrowing multiple is too high, the Superintendent, by order and subject to such terms and conditions as may be set out in the order, may reduce the borrowing multiple to any amount that the Superintendent deems in the best public interest, notwithstanding any other provision in the legislation.

Quantitative Limits

As we have discussed in Chapter V, the Task Force recommends that a prudent investment approach be adopted to replace the quality tests in the existing legislation and proposed in the consultation draft. However, we believe that the prudent strategy must also take into account the importance of diversification of investments and, in our view, the most effective means of ensuring this is through the continuation of *quantitative* restrictions on particular categories of investments.

The submissions to the Task Force bear out our own findings on this issue. In particular, the evidence of the Canadian Life and Health Insurance Association, Professor Seymour Friedland, and the Trust Companies Association of Canada was such as to favour the prudent portfolio approach to the regulation of investments by financial institutions.

We have considered the particular quantitative limits proposed in the draft *Loan and Trust Corporations Act* and are in substantial agreement with them. In respect of the proposed basket clause, however, we are of the opinion that it should be redrafted to make it clear that the basket clause should not be used in such a way as to enlarge the lending authority of corporations which have obtained the extended powers given under the commercial lending clause (s. 160 (2)). Furthermore, it should be clear that all loan and trust corporations are permitted to engage in commercial lending by the basket clause so that an evaluation of their success in using these powers can be made before any enlargement is permitted. Accordingly, *we recommend that:*

20. Common Shares

The quality tests proposed in clause 160(1)(c) of the Draft Act should be eliminated. Any proposed investment in common shares should be considered with regard to the prudent investment standards established by the investment committee and adopted by the board of directors. However, the quantitative restrictions in the Draft Act in respect of investment in common shares should be retained. These restrictions include:

(i) total investment in shares not to exceed 25 percent of total assets; and

(ii) no holding in excess of ten percent of the voting shares of any one body corporate.

21. Preferred Shares

The quality tests proposed in clause 160(1)(d) of the Draft Act should be eliminated. Any proposed investment in preferred shares should be considered with regard to the prudent investment standards established by the investment committee and adopted by the board of directors. However, the quantitative restrictions in the Draft Act in respect of investment in preferred shares should be retained. These restrictions include:

(i) total investment in shares not to exceed 25 percent of total assets; and

(ii) no holding in excess of ten percent of the voting shares of any one body corporate.

22. Consumer Lending

As proposed in the Draft Act, personal loans to any individual should not exceed the greater of $25,000 and the individual's annual income and all personal lending should be done according to the provisions in subsection 160(4) of the Draft Act including the restriction that the aggregate total of such investment is ten percent or less of the total assets of the loan or trust corporation or such lower percentage as the Superintendent of Deposit Institutions may approve.

23. Real Estate for the Production of Income

The amount of investment in real estate for the production of income should be restricted to five percent of total assets; investment in any one parcel of real estate should not exceed one percent.

24. Real Estate for Own Use

The amount of investment in real estate for the corporation's own use should be restricted to an amount equal to the capital base of the corporation.

25. Third and Subsequent Mortgages

The amount of investment in third and subsequent mortgages should be restricted to two percent of the total assets of the corporation.

26. Single Investments

The amount of investment in any single person or persons that to the knowledge of the corporation are 'related' should be restricted to one percent of the total assets of the corporation.

27. 'Open Basket'

The amount of investment in the basket should be restricted to five percent of the total assets of the corporation. The basket clause should be redrafted to clarify that it cannot be used for commercial lending by corporations that have been granted the statutory commercial lending privilege by the Superintendent and that it may be used for commercial lending by any other corporation wishing to gain experience in this area.

28. Investment Limits

The 50 percent investment limit proposed in section 165 of the Draft Act should be enacted.

Chapter VIII

The Insurance Industry

Background Considerations

The insurance industry in Ontario is comprised of several different segments each making a unique contribution to the provision of a financial product which is essential to most Canadians. We have already drawn special attention to the vital role played by independent agents and brokers in the distribution of insurance products to consumers. This chapter focusses upon the institutional members of the insurance industry.

Generally speaking, this industry is made up of two entirely different types of companies. These are stock insurance companies (stock insurers) which have their equity capital owned by shareholders in the same way as most other business corporations: they may be widely held, closely held, controlled by a holding company or by some other corporation, financial institution or combination thereof. Mutual insurance companies (mutual insurers), on the other hand, have no share capital and so are controlled, not by shareholders, but by members who are policyholders. By definition, then, they are widely held, for the most part by individuals as they cannot be a subsidiary of a holding company or other corporation. Because of this essential difference in their ownership structure, the diversification capacity of the two categories of insurers is entirely different. An upstream holding company can control a stock insurer and it can become part of a financial conglomerate offering a wide array of financial services; mutuals cannot. In addition, no mutual insurer is permitted the flexibility of investment provided by the seven percent basket clause in the Ontario *Insurance Act*.

This distinction between stock and mutual insurers becomes even more significant when one examines differences in the investment powers accorded to different types of insurers. Under the Ontario *Insurance Act*, all stock insurers and mutual life (but not mutual property and casualty) insurers are given the same powers with respect to investment in preferred and common shares and income-producing real estate. While no mutual insurer is extended the use of the basket investment power, property and casualty mutuals are further restricted in that they cannot invest in shares or in income-producing real estate. Stock property and casualty insurers are not permitted to invest in the shares of any insurance corporation; life insurers of either category may not invest in another life insurance corporation, but may in other types of insurance corporations.

Ontario chartered companies comprise a relatively small part of the Ontario insurance industry. Of 478 licensed insurance companies, 79 are Ontario incorporated, fourteen are chartered in another province, 149 are federal Canadian companies, and 236 are foreign insurers registered and regulated by the federal government. Of the Ontario-incorporated insurance companies, the majority (52) are property and casualty mutual insurers, most of which are known as the farm mutuals. There are only four life insurers (three stock and one mutual), 21 stock property and casualty insurers and two reinsurance companies chartered in Ontario.

Some companies incorporated in other jurisdictions have different powers from Ontario companies. It is important that the Ontario companies have powers which permit them to compete with other companies carrying on business here.

As well, recent developments and initiatives in other jurisdictions have brought about a demand for changes in the regulation of insurance institutions and increased powers. The passage of Bill 75 in the Province of Quebec gives Quebec chartered insurers, a number of whom are also licensed to conduct business in Ontario, the power to engage in a number of non-insurance activities and varied financial intermediation functions. While the full impact of these legislative changes is as yet undetermined, clearly the enlarged sphere of permitted activities and greater latitude in investment powers granted to these companies have the potential to expose the Government of Ontario to certain economic and political costs. If some Quebec based insurers become insolvent, for example, residents of Ontario may well expect compensation from their own government. Ontario will not have regulatory control over the business activities of an insurer outside Ontario, but nevertheless its grant of a licence to carry on business here undoubtedly will be taken by the public as giving some assurance of the stability of a licensed insurer.

In our Interim Report, we recommended that the Government of Ontario request 120 days' notice in writing from any insurance company wishing to pursue corporate activities which deviate from those allowed by the *Insurance Act* of Ontario. As an interim strategy, this recommendation has the utility of providing a period of time in which each particular situation can be analyzed and appropriate action taken in the short term. However, a solution which is more appropriate in the long term must be devised to deal with emerging issues before they become full-fledged problems. The widespread implementation of industry compensation funds, discussed in Chapter IV of this Report, offers one such solution. It has the advantage of providing protection for Ontario residents without imposing restrictions on the investment policies of insurers incorporated elsewhere.

Proposals for revision to the federal legislation governing insurance companies are discussed in the recent Green Paper and, if implemented, may also have an impact on the Ontario insurance industry for which the Ontario government should be prepared. The federal paper proposes to allow mutual insurers to create a downstream group of affiliates in order to take advantage of the holding company approach and to offer a wider range of services to their customers. Changes to the investment powers of all insurance companies are also proposed. Generally, a prudent investment approach is envisaged.

While the Canadian insurance business has not been plagued with insolvencies to the same extent as other sectors of the financial services industry, there have been a number of recent problems indicating that insolvencies certainly can occur in this industry. The recent difficulties are of great concern to the Task Force because they may be symptomatic of broader pressures and because, with the exception of the farm mutuals, there is no protection in the form of a guarantee or compensation fund for clients who may incur losses upon the insolvency of an insurer. The following discussion and recommendations deal with these issues.

Changes to the Regulation of All Insurance Companies

The Task Force received an extensive written submission, supplemented by an oral presentation, from the Canadian Life and Health Insurance Association (CLHIA).[1] It advocated extended powers for life insurance companies, including the ability to acquire downstream subsidiaries in any business, and replacement of the legal for life restrictions on investment with a prudent management approach. No formal submissions were received from the Insurance Bureau of Canada, the association representing stock property and casualty insurers, although the Task Force had met informally with this group in the initial phase of our proceedings and took heed of its concern for preserving the special role of the broker.

We are in substantial agreement with two major proposals of CLHIA. The first is the desirability of modernizing the *Insurance Act* of Ontario which has not been updated in many years. Two primary objectives should guide the formulation of the new Act: (1) the rules as to governance should

be updated to conform, so far as possible, with the principles adopted in the Ontario *Business Corporations Act, 1982;* and (2) the general principles we have recommended in this Report, notably in Chapters III, IV, and VI, in relation to the governance and regulation of all financial institutions should be implemented.

A number of the proposals made in Chapter VII on the loan and trust industry are also applicable to insurance companies, as they too must be governed and regulated to assure their financial stability to the greatest extent possible. In particular, entry requirements should be made more stringent, directors should bear a greater duty of care, more disclosure to the public is warranted, and a statutory prohibition on self-dealing similar to our proposal in respect of the loan and trust industry should be enacted. We are also in agreement in principle with the application of the prudent investment approach to the insurance industry for the reasons previously discussed in Chapter V. We make no specific recommendations on the quantitative limits for capitalization or specific standards for diversification of investment, but advise that the underlying principles used in the formulation of limits for loan and trust corporations should be applied, to the extent applicable, to the insurance sector.

The expansion of the powers of insurers to acquire downstream subsidiaries in unrelated businesses, is, however, not an initiative that the Task Force is prepared to support. We do believe, however, that mutual insurance companies should be able to take advantage of the holding company structure in the same way as some stock companies now have done and should be permitted to engage in approved networking arrangements. In other words, all Ontario insurers, regardless of their ownership, should be able to diversify equally through networking or the holding company device. We think that appropriate steps should be taken to discourage any common ownership that would result in a mix of commercial or real sector interests with interests in the insurance business.

Furthermore, it is our view that no extension of the powers of general or life insurers should be legislated until industry compensation funds that satisfy the regulatory authorities are in place. As we point out in Chapter IV, the creation and operation of compensation or guarantee funds in all segments of the financial services industry is essential to public confidence in the solvency of the financial system and to the safeguarding of the funds entrusted to financial institutions in this province. Accordingly, *we recommend that:*

1. Investment Powers

The statutory provisions respecting the investment powers of insurance companies should be amended to parallel the recommendations made in this Report regarding the investment powers of loan and trust companies.

2. Other Statutory Requirements

The following matters should be reflected in amendments to the *Insurance Act* and should parallel the recommendations made in this Report regarding trust companies:

(i) more appropriate requirements for initial capitalization and the qualifications of incorporators;

(ii) the standard of care of directors and duties of the management resources committee;

(iii) the role and responsibilities of audit committees and the development of early warning systems;

(iv) the qualifications of directors and the restrictions on cross-institutional directorships.

Mutual Life Insurance Companies

CLHIA, which represents both stock and mutual life insurance companies, argued that the regulation of these two groups should be equalized in respect of investment capacity and ability to diversify through the use of subsidiaries and affiliates.

We have not received any submission from the industry, regulators or the public opposing this treatment and we favour such equalization in principle. Elsewhere in this Report we have suggested that there are significant advantages in having financial institutions widely held. The extension of the financial holding company structure to mutual insurers is particularly appealing as they are very widely held and, accordingly, their growth will contribute to the expansion of the widely-held sector. Whether the means for such diversification is through a financial holding company or in downstream subsidiaries is a matter on which the Ontario government should consult with federal policy-makers to ensure that legislated developments at both levels are compatible and complementary.

Our caveat issued earlier concerning the implementation of satisfactory industry compensation funds prior to legislative changes in the powers of insurance companies also extends to our recommendation in respect of mutual life insurers. Accordingly, *we recommend that:*

3. Capacity of Mutual Life Insurance Companies to Own Subsidiaries or Own Shares in a Financial Holding Company

Provided that there exists a life insurance industry compensation fund that is satisfactory to the regulatory authorities, the Government of Ontario should pursue, in consultation with the Government of Canada, means which will ensure that mutual life insurance companies, as widely-held financial institutions, will not be disadvantaged *vis-à-vis* stock companies in their capacity to affiliate with other financial institutions, whether by way of the organization of a financial holding company or in downstream subsidiaries.

Ontario Farm Mutuals

The Ontario Mutual Insurance Association (OMIA), representing all 51 of the farm mutuals in Ontario, appeared at the Task Force hearings[2] to propose that they be given the same powers as other insurers to invest in common shares and to acquire downstream stock property and casualty insurance companies.

The amount of business in the farm insurance sector has decreased significantly in recent years. However, in the regions traditionally serviced by the farm mutuals, there has been a substantial increase in non-farm general insurance business, some of which is being underwritten by these companies. A number of farm mutuals which have grown extensively now wish to expand further in the non-farm insurance field, but need to do so through the use of a downstream stock insurance company, so as not to jeopardize their status as farm mutuals. In our view, there should be no impediment to such a diversification of farm mutuals provided the strict regulatory controls which we believe to be appropriate for all financial institutions are imposed, and an effective supervision system is in place. Allowing the closely-supervised expansion of qualified farm mutuals into the non-farm insurance sector will encourage the growth of an Ontario based insurance industry, promote Canadian ownership, and foster the contribution that these insurers traditionally have made to local economies by way of investment and support of local initiatives.

Ontario farm mutuals are unique among their fellow insurance companies in that they have had a successful industry-sponsored compensation fund operating for some years. The existence of this fund, in our view, argues for early extension of powers to this category of insurers, provided they meet the requirements set down by regulators.

In Chapter IV, we took the view that the existence of the OMIA compensation fund should exempt farm mutuals from required membership in any other insurance industry compensation fund. If farm mutuals are to be allowed to acquire downstream stock property and casualty insurance companies, however, there arises a compensation fund issue which in our view must be resolved. We consider that two options offer a satisfactory resolution: either the OMIA compensation fund should be extended to all downstream insurance affiliates of the farm mutuals or these downstream affiliates should be accepted members of a general property and casualty stock company compensation fund that has the approval of the regulatory authorities. Accordingly, *we recommend that:*

4. Ontario Farm Mutuals: Ownership of Stock Companies

The Government of Ontario should give notice that it intends to permit Ontario farm mutuals, subject to ministerial approval, to own downstream property and casualty companies that are stock companies on the condition that a satisfactory industry compensation fund for such stock companies has been developed and implemented. Such approval should be subject to a mutual being able to demonstrate the existence of a business plan, the fitness as to character and competence of directors and its record of experience in the property and casualty business.

Chapter IX

Credit Unions

There are over 900 credit unions in Ontario with a membership approaching two million individuals and assets totalling some $6 billion. We took special note of credit unions in our Interim Report because they have been affected particularly by the unprecedented interest rate volatility of recent years. Indeed, a number of these institutions had so severe a mismatch between short-term liabilities and long-term assets that they continue to experience difficulty in recovering from their deficit positions. The Government of Ontario has put in place a recovery program which we believe should be pursued vigorously so that credit unions which are now in difficulty may recover and so that all credit unions may be operated prudently.

The representatives of the Institute of Chartered Accountants of Ontario (ICAO) who appeared at our public hearings commented positively on the progress of the recovery program we support.[1] They noted that the monitoring function of the Director of Credit Unions of the Ministry of Consumer and Commercial Relations has been assisted considerably by the computerized information system that has been put in place by the Ontario Share and Deposit Insurance Corporation (OSDIC). They noted progress in prescribing regulations to improve the financial strength of credit unions, for example in the mandatory matching of interest-earning assets and interest-bearing deposit liabilities.

The downside is the pace at which the recovery program is proceeding. The representatives of the ICAO commented that among the numerous credit unions of small size there is often neither the expertise nor "indeed the proper attitude to comply with a standardized regulatory framework."[2] Nor are attitudinal problems confined to certain small credit unions. "There are fragmented groups, breakaway credit unions you may call them. Sometimes they are large ones who feel they are better able to run their shows than to voluntarily subscribe to policies laid down by a trade association."[3] Meanwhile, within the central leagues, "many of the credit unions who are, on the surface, subscribing to and supporting their central trade organization are quite often displaying an attitude of wanting to run their own show."[4] Turning to our own Interim Report and its characterization of the recovery period as one that may require five years, the ICAO representatives warned that "it may be read by many of the players in the credit union system as approving of a slow, slow progress and their reluctance to move quickly to a standardized system".[5]

We take this warning seriously, not least because the attitudinal problems that prompt it have been confirmed by the tone of a number of our own exchanges with members of the credit union movement. It is paradoxical to us that a movement whose very foundation lies in the co-operative principle should exhibit so many symptoms of reluctance to close ranks. We are very conscious of the likelihood that a formal examination of the root causes of this paradox might serve only to delay the pace of the recovery period. For the time being we are strongly of the view that the attention of all concerned should be concentrated on the extent of compliance with current government and industry initiatives, on accelerating the recovery of credit unions that remain in deficit positions and on enhancing the capitalization of credit unions generally. With respect to capitalization, the current

tax treatment of credit unions was brought to our attention by the representatives of the ICAO.[6] We consider that the general tax treatment of credit unions, and for that matter of other financial institutions, is a subject whose ramifications far exceed our resources and mandate. However, we consider it a virtue of the recommendations made in Chapter III with respect to a consolidation of financial institution responsibilities in the Ministry of Treasury and Economics that the development of financial institutions policy can take more readily such broad considerations into account. Accordingly, *we recommend that:*

1. Current Initiatives and Capitalization

The Ministry of Treasury and Economics should examine the initiatives that continue to be pursued by the regulatory authorities and the industry to strengthen the operation of the credit union movement with a particular view to:

(i) assessing the adequacy of compliance with these initiatives;

(ii) accelerating the recovery, by organizational or other means, of credit unions which remain in deficit positions;

(iii) bringing credit unions into positions of adequate capitalization.

In both formal and informal submissions to this Task Force, representatives of the credit union movement expressed a desire for an extension of credit union powers. There are three prerequisites that we deem essential to any extension of the current powers of credit unions.

The first is that all credit unions should be members of a stabilization fund that is acceptable to the regulatory authorities. If this has to be stipulated as a precondition, the reason lies in the fact that the Ministry of Consumer and Commercial Relations is still experiencing difficulty with certain credit unions which, not being affiliated with a central league, currently are using OSDIC as both their source of deposit insurance and their *de facto* stabilization fund contrary to an explicit policy of divesting OSDIC of the stabilization function. We are content to leave the question of whether membership in a stabilization fund can be only through a central league to negotiation between the industry and the regulatory authorities. It is essential that the stabilization fund in which membership is required have the approval of the regulatory authorities. We specifically intend that the additional powers which could become available to credit unions will constitute an incentive for the resolution of this issue.

Our second prerequisite is dictated by our recommendations affecting the internal practices of all financial institutions. These recommendations refer to the role of audit committees, to the statutory duties of auditors and to vesting in regulatory authorities the power to investigate complaints by members of the public who believe that their dealings with a financial institution have been prejudiced by a prohibited practice. Our recommendations also require a prudent investment standard and a mandatory investment committee attuned to the importance of diversification in investment. None of these is covered by existing credit union legislation. This legislation should be changed at an early date to implement these recommendations.

Our third prerequisite involves applying to credit unions the legislative provisions we have recommended specifically in Chapter VII as relevant to loan and trust corporations. In applying these provisions, it will be important to adapt some to the special nature of credit unions as co-operative institutions. Thus, for example, the minimum capital requirements recommended for loan and trust corporations are not specifically applicable to credit unions given their community and co-operative nature. Several Ontario credit unions have capital which is significantly less than these minimum

capital requirements. There are, of course, a number of provisions which are applicable to credit unions without modification, including: a statutory requirement that a credit union report any changes to its board of directors to the regulatory authorities who must satisfy themselves of the fitness as to character and competence of new directors; changes to the statutory standard of care for directors of credit unions to ensure that they have due regard for the interests of members as depositors; creation of an additional statutory duty for the board of directors to appoint a management resources committee to ensure good management of the credit union; imposition of a statutory duty on the auditors and all other persons undertaking professional services for the credit union to report simultaneously to the directors and regulatory authorities any breaches of self-dealing and conflict of interest provisions; and a statutory requirement that any suspension of a credit union's right to carry on business by the regulatory authorities or government must be reported to a standing committee of the legislature. Accordingly, *we recommend that:*

2. Preconditions for Change in Credit Union Powers

No extension of the powers of credit unions should be implemented until:

(i) every credit union, through affiliation with a central league or by other means, possesses membership in a stabilization fund that has been approved by the regulatory authorities;

(ii) a revision of credit union legislation applies to credit unions the legislative provisions recommended in this Report as applicable to financial institutions generally;

(iii) a revision of credit union legislation applies to credit unions the legislative provisions recommended in this Report as applicable to loan and trust corporations, due account being taken of the special nature of credit unions as co-operative institutions.

The consultation draft for a new *Loan and Trust Corporations Act* contains several provisions relating to self-dealing and conflicts of interest. We have endorsed many of these provisions, while making some specific recommendations for amendment. Because credit unions are co-operative institutions, they are in general entities whose depositors, directors and borrowers are all equity holders. This creates self-dealing and conflict of interest possibilities, whether among equity holders or between equity holders and managers, which may not be remediable in exactly the same terms as addressed by our loan and trust recommendations. At our public hearings, representatives of the ICAO also expressed concern about the fact that members of credit unions do not appreciate the difference between the nature of the share capital they hold in credit unions and their deposits.[7] In fact, as we have noted in Chapter IV, the availability of deposit insurance for share capital accounts means that credit union members frequently do not have any risk capital at stake in credit unions. This removes an incentive for credit union members to monitor closely the activities of management and increases the possibility that management alone, or management in collusion with members who have shown an interest in the governance of the credit union, will engage in self-dealing and other transactions replete with conflicts of interest. As a preparatory step in the revision of credit union legislation, we consider it most desirable that the Ministry of Treasury and Economics review these singular characteristics of credit unions to ensure that the latent possibility of conflicting interests will not have any prejudicial effect on the operation of credit unions. Accordingly, *we recommend that:*

3. Review of Conflict of Interest and Self-Dealing Possibilities

The Ministry of Treasury and Economics should review and report upon the singular aspect of the credit union system where the depositors, borrowers and directors are all equity owners to ensure that the latent possibility of conflicting interests may not have any prejudicial effect on the operation of a credit union.

We come now to the additional powers which in our view could be granted to credit unions once the preconditions set out above have been met. The possibility of ownership of other financial institutions either directly or through a downstream holding company was broached in a submission we received from the Civil Service Co-operative Credit Society Limited.[8] We consider that this should be addressed by the Ministry of Treasury and Economics as part of its review of potentially conflicting interests, due account being taken of the general ownership principles we outlined in Chapter V.

The other possibility of enhanced credit union powers that has come to our attention lies in the realm of commercial lending and leasing. At present, a credit union may engage in commercial lending, but only to corporations that are members of the credit union. Section 82 of the *Credit Unions and Caisses Populaires Act* specifies that such lending to member corporations may be in an amount up to seven percent of the total of unimpaired capital, deposits and surplus and, with the approval of the regulatory authorities, may be up to fifteen percent of this total.

We support the percentage limitations that Section 82 applies to commercial lending. However, the importance we attach to asset diversification prompts us to advocate that larger credit unions should be able to make commercial loans to non-members as well as members. There remains a critical size of credit union below which commercial lending should be restricted to members only because we consider, as with trust companies, that general commercial lending is a function of expertise that is not likely to be found in small entities. We consider that credit unions with total assets of at least $15,000,000, subject to the section 82 percentage limitations, should be able to make commercial loans to non-members.

We view commercial leasing, whether to members or non-members, as another matter. It requires different expertise and can involve significantly different risks than commercial lending. Credit unions should be prohibited from engaging in commercial leasing; once they have established a record of competence in commercial lending, the government may wish to reconsider this prohibition.

In this context, the current wording of the basket clause (subsection 79(2) of the *Credit Unions and Caisses Populaires Act)* is of concern to us. It could be read as possibly permitting commercial leasing, and is ambiguous as to whether it permits commercial lending to non-members. Although we have been advised by the regulatory authorities that their interpretation of the basket clause does not allow commercial lending to non-member corporations, we consider that its language should clearly prohibit both this activity and commercial leasing. Accordingly, *we recommend that:*

4. Authorization of Commercial Lending

a) **Subject to the conditions outlined in Recommendation 2, a credit union which has assets in an amount equal to or greater than $15,000,000 should be permitted to engage in commercial lending to corporations which are not members of the credit union, such lending to be subject to the provision that all corporate lending, to both members and non-members combined, will not exceed the amount which is equal to seven percent of the total of unimpaired capital, deposits and surplus or, if approval of the regulatory authority has been obtained, will not exceed fifteen percent of this total.**

b) Credit unions should not be permitted to engage in commercial leasing at this time.

c) The basket clause should be amended to provide unambiguously that it may not be regarded as authorization for a credit union to engage in commercial lending or commercial leasing of any kind.

Credit unions are mainly a provincial responsibility but federal-provincial co-operation is no less desirable with respect to their affairs than it is with respect to other financial institutions. In the all-important matter of deposit insurance, we urged in Chapter IV that achieving and maintaining coverage on identical terms and conditions should be a basic principle of public policy. Another federal-provincial dimension of concern to us arises from the relation between the Canadian Co-operative Credit Society (CCCS) and provincial central leagues. CCCS is a federally chartered organization under the regulatory jurisdiction of the federal Superintendent of Insurance. CCCS funds are derived primarily from member central leagues who must maintain minimum levels of capital contributions and deposits in CCCS. Credit Union Central of Ontario currently has approximately $100 million invested in CCCS.

CCCS, as a national organization, is a desirable source of diversification for credit union investments. The quality of those investments is a valid concern of the regulators from provinces whose central leagues are members of CCCS. By the same token, the soundness of the member central leagues is a valid concern of the federal Superintendent of Insurance because their condition impacts on CCCS. We are concerned by an apparent absence of close federal-provincial liaison with respect to the regulation of CCCS and of central leagues. Accordingly, *we recommend that:*

5. Federal-Provincial Liaison and Exchange of Information

The Government of Ontario should enter into formal consultations with the Government of Canada concerning the means whereby there could be ongoing liaison and reciprocal exchanges of information regarding the Canadian Co-operative Credit Society which is under the regulatory mandate of the federal Superintendent of Insurance and the central leagues which are under the regulatory mandate of the Ontario Director of Credit Unions.

Chapter X

The Securities Industry

Background Considerations

Ownership of the Ontario securities industry is an issue which has been subject to public, industry and regulatory scrutiny on several occasions for almost two decades. The acquisition in 1969 of a major Canadian securities firm, Royal Securities Corporation Limited, by a wholly-owned Canadian subsidiary of the U.S. firm, Merrill Lynch, Pearce, Fenner and Smith, Inc., created concern by government and industry officials over prospective foreign dominance of the Canadian securities industry. Industry concern led to the establishment in July, 1969 by the major self-regulatory organizations[1] of the Committee to Study the Requirements and Sources of Capital and the Implications of Non-resident Capital for the Canadian Securities Industry. This Committee's report[2] (the "Moore Report") led to the publication of a Joint Industry Committee position paper[3] which reviewed the report and in turn made recommendations about non-resident ownership of the Canadian securities industry to the Government of Ontario.

At about the same time as the release of the Joint Industry Committee's position paper, the Honourable William G. Davis, Premier of the Province of Ontario, announced the policy of the Government of Ontario in the Legislative Assembly on July 13, 1971:[4]

> ". . . The investment community must be responsible and responsive to the particular needs of Canada. Its owners must be amenable to these needs and aspirations.
>
> We believe it to be essential that ownership of investment companies remain substantially Canadian."

To give effect to this policy, the governmment promulgated regulations[5] limiting non-resident ownership of securities firms registered to carry on business in Ontario. Pursuant to what came to be known as the 10/25 rule, non-residents and their associates and affiliates were restricted to owning no more than 25 percent of the issued securities of any class, with no single non-resident and its associates and affiliates permitted to own more than ten percent.

In his statement to the Legislative Assembly, Premier Davis requested the Ontario Securities Commission (OSC) to review several matters dealt with in the Moore Report, including the question of public participation in securities firms and the continuing status of existing registrants which were foreign controlled. The 1972 report[6] of the OSC led to a revision[7] of the regulation concerning non-resident ownership in 1974 to a form substantially the same as its current one.[8] The present regulation maintains the 10/25 non-resident standard for investment in new securities firms and material changes in ownership of existing securities firms, and imposes conditions upon the activities of non-resident firms which were registered in Ontario in July 1971 and which were in violation of the 10/25 standard (the "grandfathered firms").

The OSC report of 1972 recognized that the *Securities Act*[9] exempted dealers, including non-resident firms, from its registration requirements, when they dealt with sophisticated members

of the Ontario public. Concern over activities in this so-called 'exempt market' led to a report in 1979[10] by the OSC to the Minister of Consumer and Commercial Relations. This report recommended that non-resident firms, apart from grandfathered firms, should be limited in their Ontario activities to transactions in foreign securities with Ontario residents and to activities incidental to the sale outside Canada of securities issued by Ontario organizations. These recommendations represented a substantial reduction in the activities that could be engaged in by non-resident firms then participating in the exempt market, and have never been incorporated into Ontario legislation or regulation.

Ownership issues were addressed next in 1981 when the OSC held a hearing into the public ownership of Ontario securities firms. These hearings led to the adoption of a policy statement[11] allowing the raising of capital through public issues of shares by Ontario securities firms, subject to certain conditions and restrictions. The resulting access to public investors as a source of capital has been tapped so far by only a limited number of firms.

What we have described already as the ongoing erosion of the four pillars led to 1982 hearings of the OSC on institutional ownership of securities firms and diversification of securities firms into new activities. These hearings culminated in a December 1982 report[12] by the OSC to the Minister of Consumer and Commercial Relations; five commissioners recommended that no investment by financial institutions in securities dealers be permitted while three commissioners recommended a ten percent limit on such investment.

A proposal by the Toronto-Dominion Bank to offer discount brokerage services led to a lengthy public meeting and an October 1983 OSC report,[13] pursuant to which the bank established its so-called Green Line Investor Service. There has not yet been evidence of great enthusiasm on the part of the other banks to pursue the opportunity to offer discount brokerage services to their customers.

In early 1984, Gordon Capital Corporation sought approval from The Toronto Stock Exchange (TSE) and the Investment Dealers Association of Canada (IDA) to separate its exempt market activities from its regulated activities by carrying them on through different corporations. The corporation carrying on exempt market activities was to have a non-resident ownership interest which would have been prohibited in the corporation carrying on regulated activities. The Board of Governors of the TSE refused Gordon Capital's application for approval and this firm requested a hearing and review of that decision by the OSC. The OSC decided that the issues raised by Gordon Capital's request required a more general inquiry and convened public hearings in the fall of 1984 to consider a broad spectrum of issues relating to the ownership of securities firms and the erosion of the four pillars. Participation in these hearings was widespread and, in February 1985, the OSC issued a report[14] to the Minister of Consumer and Commercial Relations, which shall be referred to herein as the "Dey Report".

The Dey Report recommended the immediate implementation of comprehensive changes for the regulation of participants in the Ontario securities industry. The following summary outlines its major recommendations:

(i) Non-Resident Ownership of Domestic Firms

> Non-residents, including a single non-resident, would be allowed to own securities carrying up to 30 percent of the voting rights in, and up to 30 percent of the participating securities of, a securities firm. However, if non-residents in the aggregate owned more than ten percent of any class of participating securities, a single industry investor (or a group of industry investors committed to exercising their votes as a single investor) must own securities with more than 50 percent of the equity participation and more than 50 percent of the votes. This class of investor was referred to in the Dey Report as a "significant industry investor" and will be referred to similarly in this Report.

(ii) Direct Entry by Foreign Dealers

Direct entry into the Ontario securities market by non-residents would be permitted through a new category of registration, the "foreign dealer". These direct entrants would be permitted to own approximately 30 percent of the capital of the Canadian securities industry, with an individual firm limit of 1.5 percent. Allocation of these direct entry registrations would be at the discretion of the OSC and would be restricted to Canadian subsidiaries of non-resident securities firms; subsidiaries of non-resident financial institutions carrying on business as such in Canada would not be eligible for registration as a foreign dealer.

The three remaining grandfathered firms would be regulated as foreign dealer registrants, but their individual capital limits might be permitted to exceed the 1.5 percent restriction to reflect the level of their current participation in the Canadian securities market.

(iii) Ownership by Financial Institutions

Financial institutions, including a single institution, would be allowed to own securities carrying up to 30 percent of the voting rights in, and up to 30 percent of the participating securities of, a securities firm. If any financial institution owned in the aggregate more than ten percent of any class of participating securities of such a firm, there would be a requirement for a significant industry investor.

(iv) Ownership by Non-industry Investors other than Financial Institutions or Non-Residents

These 'other' non-industry investors would be allowed to own in the aggregate securities carrying up to 49 percent of the voting rights in, and up to 49 percent of the participating securities of, a securities firm. No single 'other' investor would be permitted to own more than 30 percent of either of these securities. Any securities firm with 'others' owning in the aggregate more than ten percent of any class of participating securities would be required to have a significant industry investor.

(v) The Exempt Market

The registration exemptions of the current *Securities Act* would be removed for underwriting and trading in corporate securities; trading in government securities would not be affected and regulation would remain unchanged.

(vi) Preservation of the Four Pillars

Full service brokerage and underwriting would be preserved as protected functions of securities firms. However, the OSC would have the discretion to grant registrations to financial institutions and others providing a service requiring registration under the Act provided such a service did not impair materially the performance of the protected functions by the securities industry. The OSC would also have the discretion to approve networking arrangements whereby securities firms offered products which were not securities related or whereby others offered securities-related products on behalf of securities firms.

(vii) Advisors

No ownership or entry restrictions would apply to advisors.

(viii) Access by Domestic Investors to International Markets

> Non-resident firms would be allowed to solicit the business of certain sophisticated Ontario investors in foreign and interlisted securities. Solicitation of retail investors in Ontario for business in foreign and interlisted securities by a non-resident firm would be permitted only if that firm had registered pursuant to a new category of registration, the "international dealer".

The recommendations of the Dey Report were the focus of sustained attention and debate in the proceedings of this Task Force. The Securities Industry Capital Markets Committee, while in favour of bringing the exempt market under regulation, was otherwise in basic disagreement with the Dey Report.[15] On the other hand, certain members of the industry, notably Messrs. Neil Baker[16] and Thomas Kierans,[17] respectively of Gordon Capital Corporation and of McLeod Young Weir Limited expressed support for its prescriptive thrust.

Foreign Entry and Non-Resident Ownership of the Ontario Securities Industry

With respect to the degree of direct foreign entry at the level envisaged by the Dey Report, even those supporting its recommendations sounded a note of caution. Mr. Baker questioned whether the domestic industry has grown to sufficient stature to compete effectively if foreign dealers were permitted entry to the extent of 30 percent of the capital of the Canadian securities industry.[18] Mr. Kierans, while prepared to "live with" this recommendation, submitted that an incremental approach, which might start with fifteen percent of industry capital, might be preferable.[19] Such apprehensions, in our view, are not to be dismissed as mere expressions of narrow self-interest. The capacity of a domestic industry to withstand competition from foreign entrants is a basic consideration in the conduct of international economic relations. When that industry is the securities industry, great weight must be attached to the fact that there exists a formal declaration of policy that this industry must have domestic capacity to meet Canadian needs.

This consideration, in our judgment, propels the issue of foreign entry into the Canadian securities industry to a level well beyond the regulatory mandate of the Ontario Securities Commission, indeed beyond our own terms of reference. Both the principle and the calibration of foreign entry into the securities industry are matters of fundamental public policy which are properly the preserve of the Government of Ontario. Precisely because vast and complex considerations are involved, we attach great importance to enhancing the capacity of government, through the organizational changes recommended in Chapter III, to decide these matters in a manner that at once is informed and infused by federal-provincial consultation on international trade in services. We believe it would not be in the interests of Canada to make voluntary concessions as to foreign entry when talks are being proposed on enhanced trade in services. It is unlikely that any voluntary concession would give Canada a better bargaining position at such talks. Pending the necessary deliberations, any changes in existing policy with respect to foreign entry should be held in abeyance. This includes any change in the current regulations with respect to the so-called grandfathered firms, whose current status reflects government policy as it stands.

We have reached a similar conclusion with respect to foreign investment in domestic securities firms, a matter covered by the 10/25 ownership standard clearly enunciated by the Government of Ontario since 1971. The Dey Report asserts that its 30 percent foreign equity participation model, when coupled with a significant industry investor, "recognizes the Government's policy that ownership of Canadian securities firms must remain substantially Canadian."[20] This assertion rests on the belief that a 30 percent voting shareholder will not be able to exercise control or significant influence over a securities firms. We do not share this belief. Most securities firms currently are owned by

members of the industry who have interests ranging from ten percent to very small percentages. Even though the significant industry investor would cast 51 percent or more of the voting shares in the firm, the 30 percent shareholder would likely, in our view, wield influence so significant that it could border on control. Such a shareholder presumably would be entitled to participation on the board of directors. If that is so, this shareholder's influence will be sought eagerly by those seeking a leadership position in the securities firm. In other words, it should not be assumed that the 51 percent significant industry investor will be a united group having an identical interest. A 30 percent interest held by a foreign corporation is likely to be a permanent investment, while the significant industry investor, by its very nature, will be composed of a constantly shifting group. The question of the degree of influence which such a foreign corporation might exercise with a 30 percent interest was examined at length during our public hearings and, although differing views were expressed, the Task Force has concluded that such an interest will confer very substantial power on the foreign investor to dictate in some circumstances the policy to be followed by the securities firm and ensure in almost all cases that action will not be taken contrary to its expressed wishes. Thus, we believe, on the balance of probabilities, that the 30 percent foreign equity participation model runs counter to Ontario's policy that ownership of Canadian securities firms must remain substantially Canadian and, accordingly, that this model should not be implemented until a change of policy is enunciated formally by the government.

Having reached this conclusion, we wish to comment on the merits of enhanced foreign investment in domestic securities firms in that this topic will be deliberated while current policy is being reassessed. In the course of our hearings, the merits of the case were argued not simply on the basis of additional access to capital but on the ground that foreign investment would make available to domestic firms a particularly synergistic form of capital. Prominent among the alleged synergies are access to sophisticated technology and to new ideas and investment vehicles; improved servicing of Canadian issuers who wish to tap offshore markets; and wider offshore opportunities for Canadian investors.

As presented to us, however, the evidence that enhanced foreign ownership will contribute to these desirable ends was diffuse. While the acquisition of new technology may relate to access to additional capital, neither testimony nor written submissions identified specific technologies which can be acquired only by greater foreign participation in the Ontario securities industry. As for access to new investment ideas and vehicles, we were not told why any novel aspects of an issue in either the Canadian or foreign markets cannot be duplicated quickly by Canadian securities firms. Nor was there evidence that Canadian underwriters are lacking in the ingenuity required to develop new ideas. Furthermore, the contention that such access would flow copiously from the foreign expertise that allegedly accompanies foreign investment was seriously questioned. An employee of a grandfathered securities firm who appeared at our public hearings stated that he did not perceive any great amount of expertise flowing into Canada from his firm's U.S. parent.[21] Finally, with respect to improved access to international markets, whether on the part of investors or issuers, we were not made aware of what might make increased foreign ownership of domestic securities firms a more desirable means to these ends than direct entry by Canadians. There seems reason to doubt that foreign firms, which already are participating very successfully in international markets and serving the interests of Canadian clients there, would have any compelling reason to support a Canadian entry in which they had only a 30 percent interest. Argument was made that some of the less formidable competitors currently participating in international markets might seize such an opportunity to be associated with a Canadian firm, but the Task Force was unable to conclude that such entries would make much of a contribution to Canada's efforts to participate effectively. The international markets are dominated by a relatively small number of underwriting firms and banks which have significant power to place securities quickly and thus to contribute materially to a successful underwriting. The Canadian participants who have entered these markets successfully also tend to be large underwriters and the subsidiaries of Canadian banks which can contribute materially to the placement of securities. Thus,

we were unable to conclude that increased foreign ownership would make any significant contribution to Canada's efforts to participate successfully in this market. We also were not enlightened as to how this initiative would assist the Canadian effort to obtain access to international markets where foreign participation is discouraged. We think it more likely that such problems will be resolved in negotiations by sovereign countries. The latter consideration, of course, supports our general conclusion that changes in policy towards both foreign entry and ownership must be considered in the context of bilateral and multilateral trade in services.

This conclusion embraces the Dey Report's proposed creation of a new registration category, the international dealer, which would permit non-resident registrants to solicit trading in foreign and interlisted securities. This registration category would not have any ownership or capital limitations applying to it, except that the registration would not be available to an offshore securities firm controlled by residents of Canada which could not comply with the ownership requirements applicable to dealer registrants as recommended by the OSC model presented in the Dey Report. We cannot understand the rationale behind prohibiting offshore securities firms controlled by Canadian resident financial institutions from acquiring this type of registration, unless it is pure adherence to the principle of separation of the four pillars. If implemented, this recommendation would have the anomalous effect of expanding foreign presence in Canada while limiting the participation of firms controlled by Canadian residents. This recommendation should be held in abeyance as should any interpretation by the OSC which undermines current policies.

In the latter connection, we note that the Dey Report also recommended that non-resident ownership restrictions should not apply in any form to registrants in the category of advisor because the OSC did not perceive any threat of domination by non-residents in the business of providing investment advice. The OSC notes in the Dey Report that it already has reflected this view by issuing orders exempting five advisor registrants from the non-resident ownership restrictions.[22] This practice should be discontinued until the Government of Ontario has made a formal declaration of policy.

In light of all the above considerations, *we recommend that:*

1. Foreign Entry and Foreign Ownership

Any changes affecting foreign entry into the Ontario securities industry, the existing 10/25 foreign ownership standard and the current status of grandfathered firms should be held in abeyance so that these matters can be the subject of a formal and open declaration of policy by the Government of Ontario. In formulating its declaration, the Government of Ontario should take into account the larger context of bilateral and multilateral trade negotiations which encompass the provision of services and entail federal-provincial consultation over formulation of Canadian positions.

Capital Adequacy, Access to Capital and Competitiveness Within the Securities Industry

Recent developments in the capital markets have caused a number of market intermediaries to raise the question of the adequacy of their capital to meet the challenges created by these developments. Data and arguments have been presented to this Task Force supporting both sides of the issue of capital adequacy; some have argued that the securities industry is capitalized sufficiently to serve the needs of Canadian issuers and investors, while others have argued that improved access to capital will be accompanied by more efficient Canadian capital markets.

This Task Force does not believe that it would be desirable for it to attempt to make determinations as to the current adequacy of capital, let alone to determine what might be appropriate in the future when the needs may be very different than they are today. Instead, the Task Force believes

that the participants are in the best position to determine their need for capital from time to time in light of the demands of their business and their opportunities. However, we do believe that the freedom of participants to seek capital from various sources should be subject to appropriate public policies as to the sources of such capital. Thus, the right to have access to capital must be subject to the public policy of the Government of Ontario regarding foreign participation. It also must be subject to whatever policies the Government of Ontario ultimately adopts regarding the four pillars. Accordingly, the Task Force has concluded that the appropriate issue is not the adequacy of capital or, indeed, simply access to capital, but rather to determine how the capital needs of the industry may be served consistent with appropriate public policies. Thus, the Task Force has sought to find a method of permitting access to sufficient sources of capital to allow the industry to settle the issue of capital adequacy itself, while preserving existing policies as to foreign participation and the separation between the real and financial sectors of our economy and between financial and market intermediaries.

The traditional sources of capital for the securities industry have been retained earnings, subordinated loans, and equity investment by individuals working in the industry. As a result, the industry has been controlled by individuals working in the industry. (These individuals will be referred to in this chapter as industry investors and when making these references, we regard the definition of "industry investor" contained in the draft regulations[23] prepared by the OSC to implement the recommendations of the Dey Report as the appropriate definition.)

By government policy, investment by non-residents is subject to the 10/25 rule. However, investment by Canadian resident non-industry investors is not addressed specifically in the *Securities Act* and its regulations. But The Toronto Stock Exchange has a by-law which prohibits a single non-industry investor from owning securities carrying more than ten percent of the votes in, or from owning more than ten percent of the participating securities of, a member corporation. There is no limit on the aggregate equity of a member corporation which may be owned by non-industry investors, but TSE by-laws do require that 40 percent of the directors or partners of a member must be industry participants.

This permitted investment by non-industry members may be raised privately or publicly. If raised publicly, there must be compliance with the requirements of Policy 4.1 of the OSC. That Policy requires the issuing securities firm to take steps to ensure that no single new investor who is not an industry investor will own more than ten percent of any class of voting or participating securities, unless the consent of either, or both, the TSE or the Investment Dealers Association of Canada is obtained if the securities firm is a member of either or both. The issuing securities firm must also take steps to ensure that 40 percent of its directors are Canadians, obtain the approval of the OSC and the self-regulatory organizations for the balance of its directors, and refrain from diversifying into other sectors of the financial services industry.

In considering the capital issue, this Task Force appreciates that there are a number of factors, apart from the restrictions on foreign investment, which may limit the ability of the industry to raise capital. These include the following:

(i) Some potential investors have not been permitted to invest in the industry.

(ii) Public issues have not become widely accepted in Canada since the OSC announced its willingness in Policy 4.1 to permit public issues by investment dealers. Only four securities firms have made public issues and have raised only $23 million.[24] The U.S. experience also has indicated that there have been difficulties in relying upon public issues as an adequate source of capital.

(iii) Investments of up to ten percent in the equity of securities firms by non-industry investors have not been common. A survey conducted by the Joint Securities Industry

> Committee in 1984 indicated that, of 89 securities firms responding to the survey, only one, aside from the four firms with U.S. parents and the four firms which have made public issues, had issued more than ten percent of its voting securities to non-industry investors.[25]

The challenges presented by the changing environment of the Ontario securities industry require, in our view, the development of policies which will permit the industry to attract the capital it believes it needs in a manner consistent with the public interests referred to earlier. Foreign investment aside, there is no government policy which addresses the issue. The *Securities Act* and its regulations are silent and no action has been taken on the 1982 report of the OSC which specifically addressed the question of non-industry ownership. Only The Toronto Stock Exchange has made any attempt to outline a policy in Ontario.

The Joint Securities Industry Committee in its 1984 Report[26] and the Securities Capital Markets Committee in its submission to the Task Force[27] argued that the paucity of non-resident and non-industry investment illustrates that extensive sources of new capital exist under the current regulatory regime. The contrary view holds this paucity of investment, particularly by non-industry investors, as symptomatic of inadequate incentives for participation. We believe that the best test of these conflicting views would be to open the door to greater investment by non-industry sources subject to restrictions that we deem in the public interest.

Like the authors of the Dey Report, we consider that domestic financial intermediaries may be a potentially significant source of capital for Ontario securities firms. To be sure, the terms of reference we have pursued make us most sensitive to the significant conflicts of interest which may arise from cross-ownership of market and financial intermediaries. A financial intermediary which engages in commercial lending might be tempted to shore up a debtor in financial difficulty by promoting the sale of the debtor's securities to clients of its securities subsidiary. A financial intermediary which manages trust funds would have several conflicts if it also controlled a securities firm: for example, it might use trust funds to purchase securities being underwritten by the securities firm which are not selling well; or it might use its control over trust money to increase its distribution capacity in an attempt to win underwriting business.

We are also concerned that extensive cross-ownership between financial and market intermediaries may lead to the development of a universal banking system in Canada, similar to that in Germany and France. In both these countries, banks dominate all aspects of the capital markets. No laws or regulations segregate market intermediation activities from financial intermediation and the banks have come to dominate all securities market functions, particularly in Germany. As we pointed out in Chapter II, the universal banking systems of Germany and France yield underdeveloped capital markets when compared to the United States, Canada and Japan, countries where cross-ownership of financial and market intermediaries is restricted.

No policy which permits financial intermediaries to invest in securities firms should be allowed to confound the distinctive functions of financial and market intermediation. Any trend towards universal banking could have severe ramifications on Canadian capital markets. We agree with those who believe that the relative depth of Canadian capital markets, particularly the equity market, has contributed greatly to the growth and sophistication of the Canadian economy. Accordingly, it is our view that the public interest dictates that the control of market and financial intermediaries should remain separate.

We also regard investment by domestic non-industry investors other than financial intermediaries (which will be referred to hereinafter as "other non-industry investors") as a potentially significant source of capital for Ontario securities firms. We believe, however, that it would be most undesirable if the distinction between financial intermediaries and the 'real' economy was eliminated. It is our view that the interests of savers and investors are served best when financial intermediaries are used to channel their funds to the ultimate users. Such a system provides a discipline

which would be lacking if business interests could raise money from the public directly by owning financial and market intermediaries, creating in effect what may be described as a self-financing ring.

Thus, whatever the source of capital, our starting point is that control of securities firms registered in Ontario must remain with investors who are active participants in the Canadian securities industry. If operational control firmly remains in the hands of industry investors, securities firms will be managed by professionals who are unaffected by extraneous influences which might lead to decisions being made which are not in the interests of the securities firm and its clients, but which are in the interests of outside investors.

The key to any model improving access to capital for Ontario securities firms from non-industry investors thus becomes a determination of that level of ownership which will not interfere with the principle that control must remain in the hands of industry investors. With respect to the 30 percent threshold for any single non-industry investor that was espoused by the Dey Report, we have explained already why we discern that a 30 percent threshold shareholder is likely to wield influence so significant that it could border on control. It follows that 30 percent ownership of a securities firm by a financial intermediary might well, in the view of this Task Force, come undesirably close to confounding the financial and market intermediation functions and similarly that 30 percent ownership by an industrial or commercial corporation could eliminate the very desirable distinction between the financial sector and the real economy.

We readily admit that determination of a precise level of ownership which does not constitute significant influence is difficult. However, we believe that a 20 percent standard is more appropriate than the 30 percent level recommended by the Dey Report. The 20 percent standard represents an incremental approach which, if events prove it to be too high, is more easily reversible than a higher percentage. We note that the consultation draft of a new *Loan and Trust Corporations Act* released by the Ministry of Consumer and Commercial Relations in June, 1985 will prohibit loan and trust corporations from owning more than ten percent of the voting shares of a financial institution.[28] We consider that an exception to this prohibition should be made to allow ownership of up to 20 percent of securities firms.

Even at the 20 percent threshold, we are concerned about the degree of influence which might be exercised. As added assurance that industry investors will retain operational control of Ontario securities firms, we conclude that the significant industry investor recommendations of the Dey Report should be implemented and come into effect whenever a single non-industry investor (and related parties) owns ten percent or more of the votes in, or ten percent or more of the participating securities of, an Ontario securities firm. This requirement for a "significant industry investor" will permit non-industry investors in the aggregate to have up to 49 percent of the votes in, and 49 percent of the participating securities of, an Ontario securities firm. (With respect to definition, we accept the Dey Report's reference to an investor as including both the investor's associates and affiliates as defined in the *Securities Act*, as well as persons or companies acting jointly or in concert with the investor. For ease of reference, all others included in a reference to an investor will be described by us as "related" parties.)

The Task Force does not believe that Canadian-controlled financial intermediaries need to be treated any differently than other non-industry investors. We consider that, by restricting any single Canadian-controlled financial intermediary (and related parties) to a 20 percent equity interest, concerns over the conflicts inherent in the mixing of financial and market intermediation are alleviated. The remaining equity interest holders, who will have at least an 80 percent interest, should not permit any underwritings or actions inimical to the interests of the securities firm in order to aid the financial intermediary.

We believe that the model recommended by this Task Force, permitting, as it does, very substantial ownership of participating securities by non-industry sources will allow the industry to decide for itself what its need for capital should be in the light of the rapidly changing nature of

capital markets. There is little doubt that the financing of a securities firm presents a somewhat more difficult problem because of the volatility of the earnings of such firms than does the financing of commercial firms with records of more consistent earnings. However, the problem should not be regarded as being so overwhelming that capital may not be attracted successfully from the public by such firms. In other words, we do not believe that an industry which is so ingenious in financing new businesses with no proven earnings records and businesses which have very volatile earnings records cannot do for itself what it has done for others. We make this comment because we believe it is important that the industry continue to be independent and that this independence can be maintained best if investment firms obtain the bulk of their capital from the public and sources within the industry and not from financial intermediaries or controlling commercial and industrial enterprises. Accordingly, we think that any scheme permitting greater access to capital should be designed with this consideration in mind. We believe that the recommended model will permit the industry to obtain whatever financing events prove it needs, while maintaining its independence.

In light of all of the above considerations, *we recommend that:*

2. Non-industry Investment in Securities Firms

a) Non-industry investors, including financial intermediaries, should be permitted to own in the aggregate up to 49 percent of the voting rights in, and 49 percent of the participating securities of, a securities firm registered in the Province of Ontario, provided that no single non-industry investor, including related persons and companies, should be permitted to own more than 20 percent of either the voting rights or participating securities.

b) If any single non-industry investor, including related persons and companies, owns more than ten percent of either the voting rights in, or the participating securities of, an Ontario securities firm, then industry investors who own at least 51 percent of the participating securities and at least 51 percent of the voting rights in that securities firm must exercise their voting rights as a single investor.

c) For so long as the existing 10/25 foreign ownership standard is in place, any voting rights or participating securities held by a non-industry investor which is also a non-resident should be characterized as voting rights or participating securities held by both a non-resident and a non-industry investor.

Although we believe that the 20 percent limitation will ensure the independence of underwriting firms, we think that added safeguards should be built in even at that level. One involves the underwriting function; another the role of directors.

Underwriters serve as the linchpin between the issuer and investor during the distribution of securities. This unique position requires that the underwriter be independent of the issuer. The Task Force is concerned about lack of independence if a securities firm performs an underwriting function for a non-industry investor, or any member of a group of related non-industry investors, which has greater than a ten percent equity interest in that securities firm. We are also concerned about any underwriting done for a company related to any such non-industry investor or to any such member of a group of related non-industry investors. In light of these concerns, *we recommend that:*

3. Prohibition Affecting Underwriting by Securities Firms

A securities firm should be prohibited absolutely from underwriting, whether as principal or agent, any securities of a non-industry investor or any member of a group of related non-industry investors which owns more than ten percent of either the voting rights in, or participating securities of, that securities firm and from underwriting any securities of a person or company related to that non-industry investor or any member of that group of related non-industry investors.

The Task Force is concerned also about the influence of any directors elected to the board of a securities firm to represent the interest of a financial intermediary. Any such directors may find themselves in conflict situations because of knowledge they have gained from their association with the financial intermediary or because of the competing interests of the financial intermediary and the securities firm. We consider that any such directors in a conflict situation should behave in the manner we expect of a prudent director in similar circumstances, and, accordingly, *we recommend that:*

4. Restrictions on Directors Representing Ownership Interests of Financial Intermediaries

Any directors representing the ownership interest of a financial intermediary in an Ontario securities firm should be required to absent themselves when any matter in which the financial intermediary that they represent has an interest is being discussed or voted upon by directors.

The Exempt Market

The Dey Report advocated a tightening of the exempt market by recommending that only registrants be permitted to act as underwriters and full service brokers of corporate securities. Several representations to this Task Force took a similar position. These representations argued that registrants were at a competitive disadvantage because of unequal treatment. It was argued that the existence of the exempt market permits ownership restrictions to be escaped and allows significant non-resident participation in the Canadian securities industry. It was contended also that the expansion of the exempt market was eroding the principle of separation of functions and was creating the tremendous potential for conflicts which accompanies that erosion. Further, it was argued that the existence of the exempt market lessens investor confidence because non-registrants participating in the exempt market are not subject to any capital adequacy requirements or any ongoing regulatory supervision.

This Task Force recognizes these arguments but can draw no conclusions because little information exists about the exempt market. Most arguments made to the Task Force were impressionistic and unsubstantiated by evidence. It was significant as well that they usually were advanced by parties who, having warned that direct foreign entry should be rejected as a source of excessive competition, also wished to be insulated from whatever degree of competition the exempt market now provides. We believe that in the absence of sufficient information, the exempt market should not be narrowed in any way at this time because it sustains competition within the primary capital market, it provides small issuers with a means of raising capital less expensively than by prospectus, and it provides issuers of all sizes with the means to raise funds quickly. The competition provided by the exempt market is especially significant for small issuers since large and medium size firms have the Euromarket and the American market to provide alternative sources of financing and to act as competitive stimuli.

An efficient capital markets system is integral to a vibrant Canadian economy. Accordingly, we believe that government must always play a role in ensuring the efficiency and responsiveness of the capital markets. To do this, government must have adequate information about the capital

markets and the ability to react quickly to any adverse changes to or developments in the capital markets.

Practically the only information currently provided to the Ontario Securities Commission about the exempt market is that contained on a Form 20, which is a form required to be filed after securities transactons made pursuant to certain exemptions under the *Securities Act*. These forms only contain information about the transaction itself and not about the underwriter or agent.

Research by the Task Force on the exempt market was frustrated constantly by the dearth of public information which exists about that market. Very little is known about the participants in the exempt market and the information provided has not been reviewed or analyzed on a consistent basis. We believe more complete information should be available to regulators and the government. With regard to the exempt market, *we recommend that:*

5. The Exempt Market and Information Required from Exempt Market Participants

The current exemptions from the prospectus and dealer registration requirements of the *Securities Act* should be maintained, but any participant in the exempt market acting as agent or underwriter for an issuer should be required to provide annually the following information:

(i) capitalization;

(ii) the name of each person or company which is a holder of ten percent or more of any class of its shares and the residency and citizenship or jurisdiction of incorporation of each such holder;

(iii) a statement whether non-residents, either individually or in the aggregate, own 25 percent or more of any class of its shares;

(iv) a statement as to the nature and source of any other financing used by it;

(v) a description of the types of activities in which it and its affiliates regularly are engaged;

(vi) a listing of the exempt transactions, and their dollar value, in which it has engaged during the past year;

(vii) a description of its directors and senior managers, their citizenship, their residency and their experience in financial or market intermediation.

The Government of Ontario, in formulating its policy concerning the securities industry, requires detailed and regular information concerning the exempt market. Accordingly, *we recommend that:*

6. Reporting of Information on Exempt Market Participants

The Ontario Securities Commission should submit annually to the Government of Ontario a report setting out the information it has collected from exempt market participants.

Just as this Task Force was concerned about the independence of underwriters when a non-industry investor owns more than ten percent of the participating equity of, or votes in, a securities firm, we are concerned about a lack of independence on the part of underwriters or agents participating in the exempt market. Accordingly, *we recommend that:*

7. Limitation on the Scope of the Exempt Market

The Government of Ontario should direct that any transaction in which an exempt market participant acts as agent or underwriter shall lose its exempt character if the issuer is related to the exempt market participant.

The Dey Report resulted from public hearings convened in the fall of 1984 after Gordon Capital Corporation requested the approval of the TSE and IDA to enter into an ownership arrangement with a foreign financial institution to create a new entity which would conduct exempt market transactions. The model recommended by the Dey Report probably would alleviate the necessity for Gordon Capital Corporation to pursue its application. However, the OSC underscored the urgency with which it felt its recommendations should be implemented by the Government of Ontario and cautioned that it would deal with any applications it received which were affected by the matters dealt with in the Dey Report if it felt required to do so in the interim period before policy direction was provided by the Government of Ontario.[29] In registering our disagreement with this approach, we again emphasize our view that any response to the Dey Report is an exclusive policy prerogative of the Government of Ontario. Accordingly, *we recommend that:*

8. The Gordon Capital Corporation Proposal for Participation in the Exempt Market with a Foreign Partner

The Ontario Securities Commission should refrain from dealing with any applications, such as the Gordon Capital Corporation proposal to engage in exempt market activities in conjunction with a foreign resident, which would reflect a change in policy towards foreign participation in the Ontario securities industry until the Government of Ontario has provided specific policy direction.

Footnotes

Chapter I

1. Ministry of Consumer and Commercial Relations, News Release, "Financial Task Force Announced", 13 June 1984 (Toronto: 1984), p. 1.
2. *Report of the Royal Commission on Banking and Finance* (Ottawa: Queen's Printer, 1964), p. 108.
3. *Final Report of the Working Committee on the Canada Deposit Insurance Corporation (CDIC)* (Ottawa: Ministry of Supply and Services, April 1985) (hereinafter cited as *Wyman Report*).

Chapter II

1. *Interim Report of the Ontario Task Force on Financial Institutions* (Toronto: December 1984), p. 8 (hereinafter cited as *Interim Report*).
2. E. Neufeld, *The Financial System of Canada* (Toronto: MacMillan Co., 1972), pp. 2-3.
3. D. Gill, "Banks and Securities Markets: Some Thoughts on Evaluating Financial System Depth and Efficiency" (February 1979) as cited in Securities Industry Capital Markets Committee, *Submission of the Securities Industry Capital Markets Committee on behalf of the Alberta, Montreal, Toronto and Vancouver Stock Exchanges and the Investment Dealers Association of Canada in response to the Interim Report of the Ontario Task Force on Financial Institutions* (Toronto: May 1985), p. 22 (hereinafter cited as *SICMC Submission*).
4. J. Pesando, "Deposit Insurance and the Incentive for Excessive Risk-Taking: Alternative Strategies for Reform" (July 1985).
5. Campbell, Godfrey and Lewtas, *Submission to the Ontario Securities Commission* (Toronto: September 1983). *Authors' Note:* The Task Force assumes full responsibility for a typographical error in the chart as it appeared in our Interim Report. Line 22 of Column one, Products and Services, should read "Register and *Transfer* agent". Our apologies to Campbell, Godfrey and Lewtas.
6. D. Slater, *Submission to the Standing Committee on Finance, Trade and Economics Affairs* (Ottawa: September 1985), p. 9.
7. Cited in R. Peterson and W. Scott, "Major Causes of Bank Failures", a paper presented to the Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, 1-3 May 1985.
8. The Hon. S.H.S. Hughes, Commissioner, *Report of the Royal Commission Appointed to Inquire into the Failure of the Atlantic Acceptance Corporation Limited* (4 volumes) (Toronto: 12 September 1969).
9. J. Bovenzi and L. Nejezchleb, "Bank Failures: Why Are There So Many?", *Issues in Bank Regulation*, Winter 1985, p. 54 at p. 95.
10. Peterson and Scott, *Op. Cit.*, n.7.
11. Canada, *Hansard* (Commons) Standing Committee on Finance, Trade and Economic Affairs, *Report on the Canadian Commercial Bank*, First Session of 33rd Parliament, 1984-5 (Ottawa: Queen's Printer, 1985), p. 41:16.
12. Bovenzi and Nejezchleb, *Op. Cit.*, n.9, p. 65.

Chapter III

1. Ontario Task Force on Financial Institutions, *Public Hearings*, Vol. V, 5 June 1985, pp. 984-85 (testimony of Professor Seymour Friedland) (hereinafter cited as *Public Hearings*).
2. *Interim Report*, p. 28.

Chapter IV

1. G. Gherson, "Bank regulator needs big stick", *The Financial Post*, 21 September 1985, p. 7; A. Toulin, "Wide reforms urged for deposit insurance", *The Toronto Star*, 7 November 1985, p. E4. This estimated deficit does not include any of the payments which will be made to insured depositors of the Canadian Commercial Bank and the Northland Bank.
2. *Wyman Report*.
3. See, for example, *Submissions to the Ontario Task Force on Financial Institutions* (hereinafter cited as *Submissions*), Submission 3, April 1985, p. 9 (Canadian Bankers' Association, "Comments on the Interim Report of the Ontario Task Force on Financial Institutions") (hereinafter cited as "Submission 3"); *Submissions*, Submission 7, 26 November 1984, pp. 3-4 (Consumers' Association of Canada (Ontario), "Submission to the Task Force on Financial Institutions on the Regulation of Ontario Financial Institutions") (hereinafter cited as "Submission 7"); *Submissions*, Submission 9, 12 March 1985, pp. 9-13 (submission of Mr. J. Douglas Gibson) (hereinafter cited as "Submission 9"); *Submissions*, Submission 24, March 1985, Appendix "A", pp. 7, 9 (Trust Companies Association of Canada, "Submission to the Task Force on Financial Institutions") (hereinafter cited as "Submission 24").
4. See, for example, *Public Hearings*, Vol. 1, 29 May 1985, p. 23 (testimony of Mr. J.E. Farley, Member, Special Committee on Financial Institutions, Institute of Chartered Accountants of Ontario); *Public Hearings*, Vol. V, 5 June 1985, pp. 936-941 (testimony of Professor Seymour Friedland).
5. J. Pesando, "Government Responses to the Regulatory Challenge: The Interim Report of the Ontario Task Force and the Federal Green Paper", paper presented at the Conference on the Changing Regulatory Environment for Canadian Financial Institutions, Toronto, 22-23 May 1985.
6. J. Pesando, *Op. Cit.*, Chapter II, n. 4.
7. *Wyman Report*, pp. 28-29.
8. *Submissions*, Submission 24, Appendix "A", p. 7.
9. *Public Hearings*, Vol. VI, 10 June 1985, p. 1157 (testimony of Mr. John Hilliker, Trust Companies Association of Canada). There was some support for coinsurance from a representative of the Trust Companies Association of Canada at the public hearings. See, *Ibid.*, p. 1156 (submission of Mr. Michael Cornelissen).
10. Canadian Bankers' Association, *Comments on the Final Report of the Working Committee on the Canada Deposit Insurance Corporation* (September 1985), p. 24.
11. *Ibid.*, Appendix 2.
12. *Submissions*, Submission 7, p. 3.
13. Federal Deposit Insurance Corporation, *Deposit Insurance in a Changing Environment* (April 1983), p. III-13.
14. *Wyman Report*, p. 31.
15. *Interim Report*, pp. B-6, B-7.
16. *Submissions*, Submission 7, pp. 7-8.
17. *Public Hearings*, Vol. II, 30 May 1985, pp. 153-65 (testimony of Messrs. John Harper and Robert Forsythe, Past Presidents, Ontario Mutual Insurance Association).
18. *Submissions*, Submission 20, 14 March 1985, pp. 2-4 (letter from Ontario Mutual Insurance Association).
19. *Public Hearings*, Vol. IV, 4 June 1985, p. 708 (testimony of Mr. James Pitblado, Chairman, Securities Industry Capital Markets Committee).
20. *Wyman Report*, pp. 16-20.
21. *Ibid.*, p. 16.
22. See, for example, *Public Hearings*, Vol. III, 3 June 1985, pp. 367-374 (testimony of Mr. A. Taylor, Chairman, and Mr. R.M. MacIntosh, President, Canadian Bankers' Association) and *Submissions*, Submission 24, pp. 21-23.
23. *Public Hearings*, Vol. III, 3 June 1985, pp. 372-373 (testimony of Mr. R.M. MacIntosh, President, Canadian Bankers' Association); *Submissions*, Submission 24, p. 22.
24. *Wyman Report*, pp. 53-54.

Chapter V

1. *Public Hearings*, Vol. IV, 4 June 1985, pp. 754-55 (testimony of Mr. J. Douglas Gibson).
2. Department of Finance, *The Regulation of Canadian Financial Institutions: Proposals for Discussion* (Ottawa: April 1985) (hereinafter cited as *Green Paper*).
3. *Proposals for Revision of the Loan and Trust Corporations Legislation and Administration in Ontario* (Toronto: Ministry of Consumer and Commercial Relations, November 1983).
4. Ontario Legislative Assembly, *Interim Report of the Select Committee on Company Law*, (Toronto: 1967).
5. *Public Hearings*, Vol. I, 29 May 1985, pp. 38-39 (testimony of Mr. R. Cameron, Member, Special Committee on Financial Institutions, Institute of Chartered Accountants of Ontario).

6. *Submissions*, Submission 5, 15 March 1985, pp. 13-14, 36-37 (Canadian Life and Health Insurance Association Inc., "Submission of the Canadian Life and Health Insurance Association on the Revision of the Ontario Insurance Act") (hereinafter cited as "Submission 5").
7. *Public Hearings*, Vol. V, 5 June 1985, pp. 948-49 (testimony of Professor Seymour Friedland).
8. *Public Hearings*, Vol. VI, 10 June 1985, pp. 1216-17 (testimony of Mr. John Hilliker, Trust Companies Association of Canada).
9. *Public Hearings*, Vol. II, 30 May 1985, pp. 228-32 (testimony of Mr. J.R. Collins, Member, Special Committee of the Canadian Bar Association-Ontario).
10. *Green Paper*, p. 43.
11. *Submissions*, Submission 8, 15 March 1985, pp. 16-17 (letter from Professor Seymour Friedland).

Chapter VI

1. Public Opinion Study Conducted for the Ontario Task Force on Financial Institutions by Decima Research Limited, May 1985.
2. M. Williams, "Sears Roebuck's Struggling Financial Empire", *Fortune*, 14 October 1985, p. 40.
3. *Canadian Aero Service Ltd. v. O'Malley, Zarzycki, Wells, Terra Surveys Ltd.*, (1973) 40 D.L.R. (3d), 371; [1974] S.C.R. 592.
4. Canadian Bankers' Association, "Preliminary Comments on the Regulation of Canadian Financial Institutions: Proposals for Discussion" (July 1985), opposite p. 10.
5. *Submissions*, Submission 15, 14 March 1985 (Insurance Brokers Association of Ontario, "Submission to the Ontario Task Force on Financial Institutions") (hereinafter cited as "Submission 15").
6. "Canadian Attitudes Toward Financial Institutions and Insurance Agents and Brokers", prepared for the Canadian Federation of Insurance Agents and Brokers Associations by Environics Research Group Limited, August 1985.
7. *Submissions*, Submission 15, p. 4.
8. Parkdale Community Legal Services, Inc., *Regarding Financial Institutions and Services to Social Assistance Recipients* (submission to the Ontario Task Force on Financial Institutions).

Chapter VII

1. Ontario Ministry of Consumer and Commercial Relations, *The Loan and Trust Corporations Act, a draft for consultation* (Toronto: June 1985) (hereinafter cited as *Draft Act*), ss. 6(1)(a), 10(5)(b), 33(a), 160(4)(c).
2. *Draft Act*, ss. 221, 222.
3. *Draft Act*, ss. 7(d), 10(8)(a), 33(d).
4. *Public Hearings*, Vol. VI, 10 June 1985, p. 1154 (testimony of Mr. William Somerville, Trust Companies Association of Canada).
5. See *ublic Hearings*, Vol. VI, 10 June 1985, pp. 1167-68 (testimony of Messrs. Michael Cornelissen and Harry Riva, Trust Companies Association of Canada).
6. *Ibid.*, pp. 1167-70 (testimony of Messrs. Michael Cornelissen, Harry Riva and John Hilliker, Trust Companies Association of Canada).
7. *Submissions*, Submission 14, 29 March 1985, p. 5 (letter from the Institute of Chartered Accountants of Ontario).
8. *Draft Act*, ss. 92, 94, 96.
9. *Submissions*, Submission 23, 12 March 1985, p. 6 (letter from Trilon Financial Corporation).
10. *Draft Act*, ss. 107(2), (3).
11. *Interim Report*, p. 25.
12. *Submissions*, Submission 3, p. 21.
13. *Draft Act*, s. 145(5).
14. *Draft Act*, ss. 137, 138.
15. *Submissions*, Submission 7, p. 2.
16. *Public Hearings*, Vol. I, 29 May 1985, p. 26 (testimony of Mr. J.E. Farley, Member, Special Committee on Financial Institutions, Institute of Chartered Accountants of Ontario).
17. *Submissions*, Submission 21, March 1985, p. 8 (S. Sarpkaya, "A Brief on 'Interim Report of the Ontario Task Force on Financial Institutions' to the Ontario Task Force on Financial Institutions").
18. *Public Hearings*, Vol. I, 29 May 1985, p. 37 (testimony of Mr. Seymour Wigle, Chairman and First Vice-President of Special Committee on Financial Institutions, Institute of Chartered Accountants of Ontario).
19. *Submissions*, Submission 3; *Ibid.*, Submission 9.

20. G. Benston, "The Regulation of U.S. Banking", a paper presented at the Conference on the Changing Regulatory Environment for Canadian Financial Institutions, Toronto, 22-23 May 1985. Professor Benston reported that malfeasance was related to an additional 36 percent of 1982 bank failures. For bank failures in 1983 and the first quarter of 1984, Professor Benston reported that malfeasance was associated with eighteen percent and 35 percent of the failures, respectively. Professor Benston based his figures on the results of a paper by R. Peterson and W. Scott, *Op. Cit.*, Chapter II, n. 7.
21. Standing Committee on Administration of Justice, *Report on White Paper on Loan and Trust Companies* (Toronto: May 1984), p. 2.

Chapter VIII

1. *Submissions*, Submission 5; *Public Hearings*, Vol. II, 30 May 1985, pp. 254-355.
2. *Public Hearings*, Vol. II, 30 May 1985, pp. 151-197.

Chapter IX

1. *Public Hearings*, Vol. I, 29 May 1985, pp. 12-13 (testimony of Mr. N.H.W. James, Member, Special Committee on Financial Institutions, Institute of Chartered Accountants of Ontario).
2. *Ibid.*, p. 14.
3. *Ibid.*, p. 14.
4. *Ibid.*, p. 15.
5. *Ibid.*, p. 15.
6. *Ibid.*, pp. 21-22 (testimony of Mr. D.H. Atkins, Member, Special Committee on Financial Institutions, Institute of Chartered Accountants of Ontario).
7. *Ibid.*, pp. 18-20 (testimony of Mr. N.H.W. James, Member, Special Committee on Financial Institutions, Institute of Chartered Accountants of Ontario).
8. *Submissions*, Submission 6, pp. 1-2 (Civil Service Co-operative Credit Society Limited, "Submission to the Task Force on Financial Institutions").

Chapter X

1. The major self-regulatory organizations when this committee was created were the Canadian Stock Exchange, the Montreal Stock Exchange, The Toronto Stock Exchange, the Vancouver Stock Exchange and the Investment Dealers' Association of Canada. Currently, the major self-regulatory organizations are the same except that the Montreal and Canadian Stock Exchanges were merged in 1974 to form what is known currently as The Montreal Exchange and that The Alberta Stock Exchange is now included.
2. *Report of the Committee to Study the Requirements and Sources of Capital and the Implications of Non-Resident Capital for the Canadian Securities Industry* (May 1970).
3. *Report of the Joint Industry Committee Studying The Moore Report* (July 1971).
4. *Legislature of Ontario Debates*, July 13th, 28th Legislature, 4th Session, p. 3868.
5. Regulation 794 made under *The Securities Act*, R.R.O. 1970, as amended by O. Regs. 296/71 and 337/71.
6. *Report of the Securities Industry Ownership Committee of The Ontario Securities Commission* (Toronto: Ontario Securities Commission, April 1972).
7. Ont. Reg. 95/74.
8. Regulation 910 made under the *Securities Act*, R.R.O. 1980, as amended.
9. R.S.O. 1980, c. 466, as amended.
10. "Report to the Minister of Consumer and Commercial Relations on the Application of Ontario Securities Legislation to Non-Resident Securities Firms Not Currently Registered in Ontario", *OSC Bulletin*, December 1979, p. 420.
11. "Public Ownership of Dealers, Conditions of Registration and Institutional Ownership", *Policy Statement No. 4.1*, Ontario Securities Commission.
12. "Report to the Minister of Consumer and Commercial Relations Regarding: Institutional Ownership of Securities Dealers Registered Under the Securities Act and Diversification Into Other Businesses by Securities Dealers Registered Under the Securities Act", 4 *OSC Bulletin*, 31 December 1982, p. 579A.
13. "Report on the Implications for the Canadian Capital Markets of the Provision of Financial Institutions of Access to Discount Brokerage Services", 6 *OSC Bulletin*, 31 October 1983, p. 3731.
14. *A Regulatory Framework for Entry Into and Ownership of the Ontario Securities Indus. y: A Report of the Ontario Securities Commission to the Minister of Consumer and Commercial Relations* (Toronto: Ontario Securities Commission, February 1985) (hereinafter cited as *Dey Report*).

15. See: *SICMC Submission* and *Public Hearings*, Vol. IV, 4 June 1985, pp. 587-734 (testimony of Messrs. James Pitblado, Chairman, and Duff Scott and J.C. Barron, Members, Securities Industry Capital Markets Committee).
16. *Public Hearings*, Vol. I, 29 May 1985, pp. 95-150 (testimony of Mr. Neil Baker, Director, Gordon Capital Corporation).
17. *Ibid.*, Vol. III, 3 June 1985, pp. 508-586 (testimony of Mr. Thomas Kierans, President, McLeod Young Weir Limited).
18. *Ibid.*, Vol. I, 29 May 1985, p. 112 (testimony of Mr. Neil Baker, Director, Gordon Capital Corporation).
19. *Ibid.*, Vol. III, 3 June 1985, p. 518 (testimony of Mr. Thomas Kierans, President, McLeod Young Weir Limited).
20. *Dey Report*, p. (ii).
21. *Public Hearings*, Vol. IV, 4 June 1985, p. 621 (testimony of Mr. Duff Scott, Member, Securities Industry Capital Markets Committee).
22. *Dey Report*, p. 5.
23. "Draft Amendment to Regulation 910 Regarding Entry Into and Ownership of the Ontario Securities Industry", *OSC Bulletin*, 6 September 1985, p. 3585, s. 84 (2.3).
24. *Dey Report*, p. 7.
25. *Regulation and Ownership of Market Intermediaries in Canada: Report of the Joint Securities Industry Committee on behalf of the Alberta, Montreal, Toronto and Vancouver Stock Exchanges and the Investment Dealers Association of Canada* (September 1984), p. II-3.
26. *Ibid.*, pp. 12, II-1 to II-3.
27. *SICMC Submission*, p. 31.
28. *Draft Act*, s. 166 (b). We note that the *Bank Act*, S.C. 1980-81-82-83, c. 40, s.2 would also prohibit investments by banks in shares of financial institutions carrying more than ten percent of the total votes (s.193(2)). Since banks are the exclusive constitutional prerogative of the Government of Canada, we refrain from recommending any amendment to the *Bank Act* but reiterate our view that banks, as widely-held institutions, should not be disadvantaged *vis-à-vis* financial institutions which may be closely held.
29. *Dey Report*, p. 16.

The following background papers will be made available to the public on request:

1) *Decima Research Study Conducted for the Ontario Task Force on Financial Institutions*, #1235 May 1985.

2) *The Canadian Capital Markets to 1984.* Prepared by D. Hughes.

3) *Jurisdictional Aspects of Ontario Regulation of Financial Institutions.* Prepared by M.J. Dymond.

4) *The Causes of Insolvency: An Analysis of Canadian and American Incidents of Insolvency.* Prepared by E. Hannah, C. Horner and T. Smee.

5) *The Financial Industry: Two Decades of Change.* Prepared by M. Krossel.

Copies may be obtained by contacting:

Administration Section
Financial Institutions Division
Ministry of Consumer and Commercial Relations,
6th Floor, 555 Yonge Street
Toronto, Ontario
M7A 2H6

Telephone (416) 963-0477